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The Law Concerning Capital Gains

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THE LAW CONCERNING CAPITAL GAINS

by

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SECTION I

THE UNITED KINGDOM

FROM 1799 TO 1962

Historically, Canadian courts have tended to refer to United Kingdom procedures to support their interpretation of Canadian statutes. Decisions on the Canadian tax legislation have been no exception. Reliance on United Kingdom jurisprudence to the exclusion of relevant United States decisions is in some ways illogical in view of the much closer ties between the Canadian and the United States economies, and some similarities in the tax legislation of the two countries. However, Canadian tax statutes have adopted from the United Kingdom many well-tried phrases, and the fact that our final appellate court was until recently the Privy Council had its effect on the jurisprudence to be preferred. It is, therefore, appropriate to give detailed attention to the development in the United Kingdom of capital gains legislation.

The income tax acts in the United Kingdom have been the subject of piecemeal amendments in annual finance acts, particularly in recent years, so that the statute law is now very complicated. The simplicity of the early acts, compared with the present provisions, is a striking indication of the patchwork efforts to keep pace with changing circumstances. The Income Tax Codification Committee, which was appointed in 1927 with the special aim of making the law intelligible to the taxpayer, and which took until 1936 to report, described the legislation since 1907 as "improvisation", each amendment being to deal with a specific and relatively minor problem, and leaving the overall framework intact. One aspect of that framework is the schedular

system, which has been part of the law since 1803, and reappeared in the 1842 Act when income tax was reimposed after its cessation in 1815. The schedular system will be reviewed in detail below.

It is necessary to introduce this discussion of the tax treatment of capital gains in the United Kingdom with a definition of what is meant by the phrase "capital gain" when used herein. Drawing from the definition by the International Bureau of Fiscal Documentation:

> Capital gain will be defined as an increase of the net value of an asset, which increase has been realized by a sale, exchange, or other transaction. 1/

This definition excludes some features of what might be regarded as a capital gain within a broader definition. For instance, the restriction of the availability of depreciation allowances to a narrow range of assets, and the recapture, or "balancing" provisions in the United Kingdom tax legislation are not considered, nor are certain measures such as those in the Town and Country Planning Act of 1947 or the anti-avoidance legislation of 1960. Expressed simply, the historical review which follows discusses what meaning the courts have ascribed to the word "income" as it appeared in the legislation, and whether a "capital gain" is "income" within the purview of the legislation. To answer this, and to see how today's answer might be different from what it was 150 years ago, it is necessary first to review some early history. 2/

For a long time United Kingdom law with respect to the tax treatment of capital gains remained relatively constant. It is only in the twentieth century that any dramatic developments have occurred. The English found it necessary to resort to income taxation in 1799, some 62 years before the United States

did so. Although discontinued in 1815, the tax was reintroduced in 1842. There was no specific definition of, or even reference to, capital gains in the early legislation, and no attempt seems to have been made to regard them as a form of income subject to tax. No court questioned this omission, and it was accepted as basic that capital gains were income tax exempt. This premise was not then the subject of critical scrutiny, and appears to have been treated as confirmed by precedents. The dichotomy between capital gains and income was already well established, the distinction between capital and income having been a matter of importance long before the imposition of income tax. Cases concerning the disposition of trusts and estates, where it was necessary to define the rights of the life tenant and those of the remainderman produced a line of decisions distinguishing income from the source of the income. Those decisions were both influenced by, and an influence on, the economic and social views of the period. The general attitude towards land, being the basic type of property, and the fundamental mainstay of wealth, was that it was regarded as a source of wealth not to be encroached upon. 3/ This was the social, economic and legal framework within which the early income tax statutes were created, and therefore there was no suggestion that capital gains should be taxed. Wealth was thought of in terms of so many pounds a year, emphasis being put on the annual yield to be derived from property rather than on the value of the property itself. Thus in the Act of 1842, the word "annual" was used to describe the type of income that was properly the subject of tax. By implication this excluded those casual profits from dealing in property which would not be regarded as of a recurring nature.

Although finance acts in the 19th century introduced revisions to the legislation which have considerably altered the first Act of 1799, the status

of capital gains remained unchanged until after the first World War. They were not specifically defined as income by the legislation, and were not regarded as such by the courts. Nor was there any attempt to deal with, or explain this treatment. The courts were not called upon, as they were later, to explain the exclusion in terms of the Statutory Schedular scheme, and to apply the ejusdem generis rule of construction. Nor were they required to analyze the words "annual income" which appeared in the 1842 Statute. Explanations, apparently unnecessary then, were eventually given in the course of judicial attempts to rationalize the broadening view of income and to bring within the existing system some forms of gains which previously had enjoyed the protection of being classified as capital gains. These developments did not occur until the 1920's. Previously the courts, and presumably the legal profession generally, accepted the capital-income dichotomy without question. A substantial body of non-tax law had, by 1800, entrenched the distinction between capital and income into the common law. The distinction was essential to the determination of property law problems as to how to allocate property rights between a life tenant and a remainderman, a tenant in tail and the donor's heirs, or the beneficiaries under a trust settlement and the trust property. Underlying these legal concepts was the social fact that land was infrequently sold. The use of limited estates allowed for enjoyment limited by the inability to dispose of it. As the land could not be sold by the person enjoying it, it was regarded only as a source of his wealth and not itself as an item of his wealth. This basic social factor may account in large measure for the inclusion into income subject to tax, by statute and interpretations thereof, the enjoyment of the property but not the property itself.

Another basic precept which emerged from the taxing statutes to distinguish capital from income and which can be traced to earlier English

property law is that which pertains to the word "annual". This was used to help describe the type of income that was considered to be properly included within the income tax net. When introduced into the Finance Act in 1842, it was descriptive of the usual type of enjoyment to which a life tenant or tenant in tail was entitled, for instance the annual produce of an agricultural land holding. Its object seems to have been to bring into income for tax purposes only that type of income that, under the conditions of the day, could be expected to recur on an annual basis. Such principle might apply equally to annual wealth accruing to an individual from the regular enjoyment of his skills and labour as to a merchant's profits from his trading activities. On the other hand, it would appear to exclude from the income base those profits resulting from casual dealings in property which cannot be expected to be of a recurring nature, and also, presumably, those profits resulting from casual employment of a personal skill or ability. Although these principles stemmed from the law of real property, their philosophy permeated other aspects of the social structure so that they were considered acceptable in respect of, for instance, personal property, despite the restricted use of limited estates in respect of personal property.

Thus, income for tax purposes had to be of a type that represented the enjoyment of property rather than any gain accruing to the property itself, and receipts from sources that could not be expected to produce recurring income were not considered to be taxable income.

It was over one hundred years before the United States courts were faced with these problems and until then there was no attempt in the common law countries to determine on a logical basis why the dichotomy developed for one legal purpose should of necessity be applied to income tax law. Then the

United States courts examined the word "income" and determined that it included "profit gained through the sale or conversion of capital assets", but the United Kingdom courts maintained their concept of income that excluded gains from conversion of capital. Neither country has varied from their respective views of "income" despite the developing complexity of the economies and taxing statutes, and the proportionately increasing number of property transactions and relatively greater profits therefrom. Eventually, legislation was needed in both countries, in the United States to temper the tax effect of the all-embracive view of "income", and in the United Kingdom when finally the restrictive view of "income" proved also to be untenable.

The approach to "income" in the United Kingdom was fostered by the form of the tax statutes. Unlike the United States and later the Canadian legislation, where the treatment of income purported to be all-inclusive, and to bring into taxable income "income" from all sources, the United Kingdom statutes only imposed tax on the profits and gains from specifically designated sources. There are five schedules in the finance acts of which only four are now in operation, being Schedules B to E, Schedule A having been abolished in 1964. However, the tax, although ascertained and measured by different rules according to the source of the income, has remained one tax, being a tax on profits of an income nature. It is not an exhaustive tax but only a tax on those items of income which come within the schedules. No definition of "income" is given or attempted so that only those profits (a) derived from a designated source and (b) having the quality of income, are chargeable to tax. Thus, even Schedule D Case VI has been interpreted to extend only to profits of an income quality. 4/ The necessity for an income quality was first breached in 1962 by the addition of Case VII, which will be discussed in detail later.

The provisions of the finance acts and income tax acts were all consolidated as, and replaced by, the Income Tax Act, 1952. 5/ The five Schedules, A to E, classify sources of income, and the six cases (increased to eight in 1962) of Schedule D are a subsidiary classification. Schedule D is in section 122 and its cases are in section 123. Schedule D is concerned with profits of trades and professions, and profits and gains not falling in any of the other schedules. Sections 122 and 123 read:

> 122. Schedule D. — The Schedule referred to in this Act as Schedule D is as follows —
>
> SCHEDULE D
>
> 1. Tax under this Schedule shall be charged in respect of—
>   (a) the annual profits or gains arising or accruing—
>   (i) to any person residing in the United Kingdom from any kind of property whatever, whether situated in the United Kingdom or elsewhere; and
>
>   (ii) to any person residing in the United Kingdom from any trade, profession, employment or vocation, whether carried on in the United Kingdom or elsewhere; and
>
>   (iii) to any person, whether a British subject or not, although not resident in the United Kingdom, from any property whatever in the United Kingdom, or from any trade, profession, employment or vocation exercised within the United Kingdom; and
>
>   (b) all interest of money, annuities and other annual profits or gains not charged under Schedule A, Schedule B, Schedule C or Schedule E, and not specially exempted from tax,
>
> in each case for every twenty shillings of the annual amount of the profits or gains:
>
> Provided that profits or gains arising or accruing to any person from an office, employment or pension shall not, by virtue of this paragraph, be chargeable to tax under this Schedule unless they are chargeable to tax under Case V of this Schedule or under Chapter IV of Part VII of this Act.
>
> 2. The provisions of paragraph 1 of this Schedule are without prejudice to any other provision of this Act directing tax to be charged under this Schedule, and the tax so directed to be charged shall be charged accordingly. 6/

123. Mode of charge under Schedule D; the six "Cases".—
(I) Tax under Schedule D shall be charged under the following Cases respectively, that is to say—

Case I — tax in respect of any trade carried on in the United Kingdom or elsewhere;

Case II — tax in respect of any profession or vocation not contained in any other Schedule;

Case III — tax in respect of—
(a) any interest of money, whether yearly or otherwise, or any annuity, or other annual payment, whether such payment is payable within or out of the United Kingdom, either as a charge on any property of the person paying the same by virtue of any deed or will or otherwise, or as a reservation out of it, or as a personal debt or obligation by virtue of any contract, or whether the same is received and payable half-yearly or at any shorter or more distant periods [but not including any payment chargeable under Case VII of Schedule D]; and
(b) all discounts; and
(c) profits on securities bearing interest payable out of the public revenue, other than such as are charged under Schedule C;

Case IV — tax in respect of income arising from securities out of the United Kingdom, except such income as is charged under Schedule C;

Case V — tax in respect of income arising from possessions out of the United Kingdom;

Case VI — tax in respect of any annual profits or gains not falling under [any other Case of Schedule D] and not charged by virtue of Schedule A, Schedule B, Schedule C or Schedule E,

and subject to and in accordance with the provisions of this Act applicable to the said Cases respectively.

(2) The provisions of subsection (I) of this section are without prejudice to any other provision of this Act directing tax to be charged under one or other of the said Cases, and the tax so directed to be charged shall be charged accordingly. 7/

The word "trade" in Case I is defined in section 526 as follows:

"Trade" includes every trade, manufacture, adventure or concern in the nature of trade.

Contrary to the legislative scheme in Canada and the United States, where all the taxpayer's income is included into what the Americans call "gross income", the United Kingdom only taxes the gains from designated sources set out in Schedules A to E. Under such a schedular system, gains derived from an undesignated source escape taxation. Until the recent legislation, Schedule D was that most pertinent to the question of capital gains, and it charged "the annual profits or gains arising from any kind of property whatever" and then enumerated in Cases I to V specific sources to be included. Case VI was a catch-all "basket" case-charging tax "in respect of any annual profits or gains not falling under any of the foregoing Cases".

If the courts had held that profits or gains brought into charge by this were to refer back to the words "any property whatever", it may have been possible to include capital gains realized from property transactions within the purview of Schedule D. However in 1930, this matter was determined by the House of Lords in Jones v. Leeming 8/ where Viscount Dunedin said:

> Case VI sweeps up all sorts of annual profits and gains which have not been included in the other five heads, but it has been settled again and again that that does not mean that anything that is a profit or gain falls to be taxed. Case VI necessarily refers to the words of Schedule D—that is to say, it must be a case of annual profits and gains—and those words, again, are ruled by the first section of the Act, which says that when an Act enacts that income tax shall be charged for any year at any rate, the tax at that rate shall be charged in respect of the profits and gains according to the Schedules.
>
> The limitations of the words "profits and gains" were pointed out by Lord Blackburn long ago in the case of Attorney v. Black, when he said (L.R. 6 Ex., at p. 308) that profits and gains in Case VI must mean profits and gains ejusdem generis with the profits and gains specified in the preceding five Cases.

Case VI was thus confined to charging miscellaneous items of income which are more or less of the same nature as the profits or gains with which

the other cases are concerned. Capital accretion, whatever else may fall within Case VI, does not fall within Case VI, and it is not taxable for the reason that it is not a source.

Taken together with the rule of construction that an amount must be brought squarely within the words of the statute in order to be liable to taxation, the schedular system, from a jurisprudential standpoint, is the explanation of why capital gains escaped being taxed, notwithstanding the views of the United States courts and attempts by the Revenue to expand the income net by case-law. The traditional distinction developed in real property law, although undoubtedly an underlying force, was not the reason given by the courts to rationalize the exclusion of capital accretions from taxable income.

The developments in the delineation of capital gains by the courts from 1920 to 1962 are of significance, but other contributions to the importance of the period are the reports of two Royal Commissions one in 1920, and the second in 1955. 9/ While the latter Commission specifically dealt with the possibility of including capital gains within the sphere of the income tax, the former did not, and indeed it would appear that the distinction between income gains and capital gains was so firmly entrenched in the system that it was not even considered relevant to include the subject of capital gains in a discussion of the "income" tax. Even if the taxation of capital gains had been within the terms of enquiry of the 1920 Commission, it would appear that such a suggestion would have been rejected. For it said in its report:

> It is not easy by legal definition to discriminate between two transactions, having many superficial points in common, one of which would be generally admitted to be a capital transaction, while the profits of the other would at once strike the ordinary mind as a suitable and proper subject for Income Tax.

> Profits that arise from ordinary changes of investments should normally remain outside the scope of a tax, but they should nevertheless be charged if and when they constitute a regular source of profit. 10/

However, the Commission was concerned about the state of the law relating to treatment of casual or occasional profits. Section VII of the Report is entitled "Casual Profits", and it dealt with the notion that casual profits, as they were not of a type that could be expected to recur "annually", could not be taxed, as the statute used the qualifying adjective "annual" when delineating taxable income. The Commissioners considered this to be inequitable, and recommended as follows:

> 91. We are of opinion that any profit made on a transaction recognizable as a business transaction, i.e. a transaction in which the subject matter was acquired with a view to profit-seeking, should be brought within the scope of the Income Tax and should not be treated as an accretion of capital simply because the transaction lies outside the range of the taxpayer's ordinary business, or because the opportunities of making such profits are not likely, in the nature of things, to occur regularly or at short intervals.

This recommendation entailed a broadening of the concept of income, but Parliament did not implement it. However, the recommendation was soon, in large measure, incorporated into the law, for in 1923 Rowlatt, J., said in Ryall v. Hoare: 11/

> ...it seems to me that "annual" here can only mean "in any year" and that the "annual profits or gains" means "profits or gains in any year as the succession of the years comes around."

Thus the word "annual" came to include a gain arising in any year, rather than meaning only those gains which were of such a nature that they arose each year. Isolated transactions thus became a subject of taxation. This case came when the climate of the times was such that the limiting

concepts of the past were being examined and changed to meet contemporary realities. Its significance is all the more striking when viewed against a historical background that had established a connection between infrequency of dealings and the immunity of capital gains.

Another example of this preparedness to take note of modern trends for assistance in interpreting problems arising in the postwar economy is the case of Pool v. Guardian Investment Trust 12/ where the United States case of Eisner v. McComber 13/ was discussed, in which case it was said:

> Here we have the essential matter; not a gain accruing to capital; not a growth or increment of value in the investment; but a gain, a profit, something of exchangeable value, proceeding from the property, several from the capital, however invested or employed, and coming in, being "derived", that is, received or drawn by the recipient (the taxpayer) for his separate use, benefit and disposal, that is income derived from property. Nothing else answers the description.

Thus the shape of what is now regarded as a capital gain started to evolve. The distinction between the gain "accruing to capital" and that "derived from capital" rendered possible the taxation of the latter gain within the framework of Case 1 of Schedule D, which included, by use of the word "trade", profits derived from "an adventure or concern in the nature of trade". The courts now brought into play the definition of trade to assist the law to develop in response to changing conditions. By adapting the old phrase to a modern setting, "adventure or concern in the nature of trade" was employed to charge to tax gains that had previously been regarded as an accretion of capital. Considering the importance now attached to that phrase it is extraordinary that it was not discussed by a court before 1926. As the Canadian Exchequer Court said in 1956:

> Strangely enough, the meaning of the expression "adventure in the nature of trade", although it had been in the United Kingdom Act from as early as 1803, was not discussed in any case to which my attention has been directed prior to the decision of the Scottish Court of Session in C.I.R. v. Livingston et al. (1926), 11 T.C. 538, to which I shall refer later, although there is a reference to it in Californian Copper Syndicate Limited v. Harris (1904), 5 T.C. 159 at 165. 14/

In 1927 the Income Tax Codification Committee was appointed to review the by then complex and disorganized income tax legislation, and it was charged with drafting a new bill more "intelligible to the taxpayer" without substantially affecting his liability to tax. The Committee reported in 1935 that:

> We have not attempted a definition of "income" for income tax purposes, but have provided a complete classification of all the various kinds of income which are taxable. 15/

Thus the schedular form of the Act was continued, with taxable income limited to those items specifically listed, with the concomitant acknowledgment that there may be other forms of gains considered from an economic point of view to be income but which, as they were not scheduled, were not subject to tax. The Committee considered a suggestion that the draft bill should contain an express statement that income for the purposes of the bill does not include any increase or increment of capital, on the ground that there is implicit in the existing law a general principle, which has been acted upon in many decided cases, that receipts of a capital nature are not liable to income tax.

The Committee referred to the judicial comments that income tax is a tax on income, not on anything else, and declined to include such a statement as it felt the problems of defining capital were as great, if not greater, than those of defining income. The Committee did not otherwise discuss this

problem, and the uncertainty surrounding the question of what is, and what is not, "trade", remained.

The development of capital gains jurisprudence thereafter became concerned with the difficult problem of articulating under what circumstances an accretion in the value of property would be regarded as resulting from an adventure or concern in the nature of trade. This developed into a search for those criteria which would define the type of conduct that would attract tax within the expanded concept of Case 1. In so far as the main elements of the problem were not considered to be questions of law, but of fact, the part played by the General and Special Commissioners in the determination of the "badges of trade" was significant. As the determination of questions of fact was, and still is, their exclusive domain, this posed the problems which are always associated with appeals from quasi-judicial bodies, and contributed to the confusion which surrounds the expanded concept of Case 1. Although serious attempts were made to establish principles to determine the difference between questions of fact and of law, the following passage from Simons Income Tax shows how tortuous the problem still is:

> The High Court only considers appeals on questions of law, and will not disturb a finding of pure fact by the General or Special Commissioners, unless there is no evidence to justify the finding, or where incorrect reasons of law prompt their conclusions of fact, or where the Commissioners have taken an erroneous view as to the nature and effect of a document, or have applied erroneous tests in arriving at their conclusion, or have otherwise misdirected themselves in law, or drawn a wrong inference from the facts. The Court has sometimes treated what is described in the case stated as a question of law as one of fact; it decides on the case what the nature of the problem is, and will not decide a question of fact merely because the case says that it is one of law et e contra. 16/

From a review of the judicial attempts to distinguish questions of fact from those of law, it would appear that where a court felt it should

review a Commissioner's finding, it usually found a way to do so, whereas it could just as conveniently refrain, if it so wished, on the ground that the finding was one of fact. However, the 1955 Royal Commission on the Taxation of Profits and Income culled from the jurisprudence what it felt to be six tests for determining if a transaction was an adventure or concern in the nature of trade. The fact that the question as to whether capital gains should be taxed was included within the terms of the 1955 Commission suggest that, far from being settled, the question of the suitability of including capital accretions in the tax base continued to be a matter of concern. The Commission's conclusions were reached after a thorough study of the existing treatment of capital accretions, the experience of other countries (particularly the United States), economic considerations, and memorandum submitted by the Board of Inland Revenue in response to the question:

> What are the Board's views on the question of taxing capital gains and what revenue might be expected from such a tax?

In the result, there was a Majority Report recommending that realized capital gains should not be taxed and a Memorandum of Dissent strongly advocating their taxation. There was unanimity on the point that gains on assets acquired with a view to profit-making should continue to be taxed. The majority argued that any alteration in the tax treatment of capital gains would lead to greater inequities and problems than those it was intended to solve. They appeared to be impressed with economic arguments against such a tax, and particularly emphasized that assertions that such a tax would restrain inflationary tendencies seemed inconclusive. The minority dealt with the Majority Report's general arguments in the course of advancing explicit evidence in support of an expansion of the concept of taxable gains.

The culmination, then, of this period of development in the United Kingdom jurisprudence on capital gains, was the crystallization in the Majority Report of the "badges of trade" which are drawn from the many cases which the courts were concerned with in the years from 1920 in trying to elucidate the phrase, "adventure or concern in the nature of trade". The following extract from that Report sets them out:

> 116. We concluded that it was better that there should be no single fixed rule. This means that each case must be decided according to its own circumstances. The general line of enquiry that has been favoured by appeal Commissioners and encouraged by the Courts is to see whether a transaction that is said to have given rise to a taxable profit bears any of the "badges of trade". This seems to us the right line, and it has the advantage that it bases itself on objective tests of what is a trading adventure instead of concerning itself directly with the unravelling of motive. At the same time we have noticed that there has been some lack of uniformity in the treatment of different cases according to the tribunals before which they have been brought. This seems to us unfortunate and, for the sake of clarity, we have drawn up and set out below a summary of what we regard as the major relevant considerations that bear upon the identification of these "badges of trade".
>
> (1) <u>The subject matter of the realisation</u>. While almost any form of property can be acquired to be dealt in, those forms of property such as commodities or manufactured articles, which are normally the subject of trading are only very exceptionally the subject of investment. Again property which does not yield to its owner an income or personal enjoyment merely by virtue of its ownership is more likely to have been acquired with the object of a deal than property that does.
>
> (2) <u>The length of the period of ownership</u>. Generally speaking, property meant to be dealt in is realized within a short time after acquisition. But there are many exceptions from this as a universal rule.
>
> (3) <u>The frequency in number of similar transactions by the same person</u>. If realisations of the same sort of property occur in succession over a period of years, or there are several such realisations at about the same date a presumption arises that there has been dealing in respect of each.
>
> (4) <u>Supplementary work on or in connection with the property realized</u>. If the property is worked up in any way during the ownership so as to bring it into a more marketable

condition; or if any special exertions are made to find or attract purchasers, such as the opening of an office or large scale advertising, there is some evidence of dealing. For when there is an organized effort to obtain profit there is a source of taxable income. But if nothing at all is done, the suggestion tends the other way.

(5) The circumstances that were responsible for the realisation. There may be some explanation such as a sudden emergency or opportunity calling for ready money, that negatives the idea that any plan of dealing prompted the original purchase.

(6) Motive. There are cases in which the purpose of the transaction of purchase and sale is clearly discernible. Motive is never irrelevant in any of these cases. What is desirable is that it should be realized clearly that it can be inferred from surrounding circumstances in the absence of direct evidence of the seller's intentions and even, if necessary, in the face of his own evidence.

The majority concluded that realized capital gains should not be brought under a general charge to income tax or surtax as constituting income. It is important to keep in mind the types of capital gains that were the subject of that conclusion. Their Report expressed satisfaction with the then current law with respect to the taxation of non-business profits resulting from the disposition of assets originally acquired with a view to profit making. The above conclusion therefore only applied to non-profit-motivated gains. Paragraph 110 reads:

> In our view the line of distinction represents a real difference between two kinds of profit, which we do not wish to see abolished so long as we can feel satisfied that the distinction is capable of being given effect to with reasonable certainty in its application to actual cases. This seems to be the crux of the matter. For, when each case has to be decided on an assessment of the available evidence, one person may be exempted through the sheer absence of any determining circumstance, even though he has been just as much a dealer in fact as another who is found to be liable....If there could be laid down some uniform test that could apply in order to determine on which side of the line a case lay the charge of tax would be likely to fall more evenly, and therefore more satisfactorily, upon the persons whose transactions brought them to the fringe of this liability.

The problem, then, was whether there was a more equitable method for determining the distinction between taxable and non-taxable gains, or for determining the presence of profit motivation. If the test were to be property acquired with a view to profit-seeking, any transaction, as the majority pointed out, would involve some contemplation of an increase in value and realization thereof, even if not regarded as a business transaction. Lord Buckmaster's famous comment was reproduced at paragraph 112:

> An accretion to capital does not become income merely because the original capital was invested in the hope and expectation that it would rise in value. 17/

The majority pointed out that:

> If motive is to be ascertained, it is better ascertained by being imputed as the automatic result of prescribed conditions than by an attempt to search the mind of the taxpayer himself.

Therefore the majority advocated that the six "badges of trade" be applied to each case. They expressed the hope that the use of these relatively objective tests would make the determination of motive unnecessary and would reduce the uncertainty and lack of uniformity in judicial decisions. The main conclusion, that capital gains as described should not be brought into income, was largely based on economic grounds. The exemption for non-profit-motivated gains was in response to the inconclusiveness of the proposition that the absence of such a tax contributes to the course of inflation; the economic premise they did not accept was that realized capital gains are particularly likely to be withdrawn from investment and expended in consumption.

While admitting the probability that spending will be higher at a time when general conditions are such as to create capital gains, the majority

found no conclusive evidence that such a probability was accentuated by the actual disposition of securities to finance spendings (so that it would be directly checked by a tax on realized gains). They were inclined to give as much credence to the opposing argument that an individual who finds his position on capital account strengthened becomes less concerned than before to refrain from spending the whole of his current balance or to maintain the level of his bank balance. They felt that while a capital gains tax would deter investment in securities and real property, the advantages of such a tax could be more easily and directly attained by monetary policy. They thought that on balance capital gains would continue to be saved and that it would be upon savings that the type of capital gains tax being considered would fall, so that savings would be adversely affected. They discussed extensively the inequities of taxing capital gains, but assumed an unnecessarily severe form of taxation, and then pointed out its unreasonable and inequitable effects. They gave little attention to the inequities of <u>not</u> taxing capital gains. The concept of capacity to pay was dismissed at paragraph 99:

> ...thus we are not at all impressed by the argument that the taxation of capital gains would achieve a more equitable distribution of the tax burden between one taxpayer and another.

The three Commissioners who dissented from the conclusions of the majority with respect to the tax treatment that should be accorded capital gains backed up their position with cogent arguments. They did not sign the final Report "because of a fundamental difference of view between ourselves and the Majority as to the basic requirements of an equitable system of income taxation". They felt that a system of progressive taxation could only be equitable if the base (i.e., the income subject to tax) "provides a measure which is uniform, comprehensive and capable of consistent application to all

individuals". They felt that "Impartial assessment of the relative taxable capacity of individuals is impossible if the definition of taxable income is unduly restricted, ambiguous or biased in favour of particular groups of taxpayers".

The minority then stated what they felt to be the true concept of income required to secure an allocation of taxes in accordance with taxable capacity, or ability to pay. They stated:

> The taxable capacity of an individual consists in his power to satisfy his own material needs, i.e., to attain a particular living standard. ...Thus the ruling test to be applied in deciding whether any particular receipt should or should not be reckoned as taxable income is whether it contributes or not, or how far it contributes, to an individual's 'spending power' during a period.

On this basis the minority felt that most of the principles that had been applied in the past to determine whether an item was income were irrelevant (e.g., whether receipts are regular or casual, whether they come from a separate source or are payment for services rendered, whether they constitute profit on sound accounting principles, or whether they fall within the limited class of receipts identified as income by their own nature).

> In fact no concept of income can be really equitable that stops short of the comprehensive definition which embraces all receipts which increase an individual's command over the use of society's scarce resources — in other words, his 'net accretion of economic power between two points of time'.

The minority pointed out that the case law, far from gradually evolving any clear principles, had left matters in greater uncertainty than they were before. They referred to paragraph 91 of the report of the 1920 Royal Commission on the Income Tax, which stated:

> A transaction in which the subject matter was acquired with a view to profit seeking, should be brought within the scope of the income tax, and should not be treated as an accretion of capital simply because the transaction lies outside the range of the taxpayer's ordinary business, or because the opportunity of making such profits are not likely, in the nature of things, to occur regularly or at short intervals.

On the other hand, that Commission had stated in paragraph 90:

> Profits that arise from ordinary changes of investments should normally remain outside the scope of the tax, but they should nevertheless be charged if and when they constitute a regular source of profit.

To the 1920 Commission, the key was not regularity or recurrence, but the view to profit seeking; when the subject matter of the transaction is an "investment" the motive of profit seeking should not be presumed, unless such transactions occur with sufficient frequency to constitute a regular source of profits. The minority of the 1955 Report felt that this approach was unsatisfactory. A test based on motive is defective in its vagueness and in uncertainty of proof, as well as being irrelevant. It ignores the fact of a net material benefit to the recipient. Thus, the minority said in paragraphs 13 and 14 of the Memorandum of Dissent:

> From the point of view of taxable capacity it is irrelevant whether an increase in spending power occurs as a result of an unexpected windfall, or whether it was expected, planned or achieved in the course of a business organized for the purpose.
>
> The position now appears to be that a purely isolated profit is taxable, if the underlying transaction carries with it 'the badges of trade'. But the question whether it carries such a badge or not, appears to be decided not on motive, not on whether abusiness had to be organized for the purpose, but simply on whether the transaction involved speculation of a rare kind (such as the purchase and sale of toilet paper by a money lender; of whisky in bond by a woodcutter; or of farms by a motor engineer) rather than speculation of the more usual kind involving operations on the Stock Exchange or the produce exchanges.

In paragraph 15 the minority quoted the majority argument that "referability to a defined source is essential to permit of a receipt being categorized as income". Though "all profits that arise from the utilisation of property are made in a sense out of capital" only those profits are income "which arise out of something more substantial than the mere occasion of the profit itself. Income, it has been said, is the fruit that ripens on and can be plucked off the tree. If there is to be income therefore there must not only be fruit but also a tree. This substance is to be found where the person concerned has been conducting a venture or concern in the nature of trade out of which the profit arises. That is equivalent to saying that he was a dealer, even if he made only one deal. But the profit that is taxed in such a case is the income arising from the venture: it is meaningless to say that what is taxed is the profit from the sale itself".

In paragraph 16, the minority stated they were unable to follow these arguments. They felt that the "rare" speculations are no different from stock exchange speculation involving the buying and selling of particular shares:

> If the one is deemed to have committed his capital to a venture, so has the other; if the one is to be decorated for the occasion with the "badges of trade", so should the other. The ordinary man (whether he accepts it as adequate or not) might be able to follow a line of reasoning according to which the profits of a regular business are to be distinguished from isolated or casual profits which a man might obtain outside his regular activities once or twice in a lifetime. But we submit that he would be quite unable to appreciate the equity of regarding certain profits as taxable even though they be isolated or casual, and other profits as exempt, even though they may be recurrent or regular — simply because in the one case the transaction is deemed to have an atmosphere of a "venture in the nature of trade" about it, and in the other case this atmosphere (owing to the very ease with which the transactions can be conducted) is absent.

In paragraph 17 the minority again quoted the majority to refute the arguments of the latter that "referability to a defined source" is required. They pointed out that even under the then current law there is that "limited class of receipts that are identified as income by their own nature". The minority felt "it would still be necessary to show cause why these profits [i.e., capital gains] should not be admitted to the membership of that limited class".

In footnote 6 on page 361, the minority stated:

> The ambiguity of the law in this context is just as important as the gaps in the law. So long as the taxability of certain classes of profits is subject to so much uncertainty, it is hardly to be expected that the taxpayer will regard such profits as part of his income for tax purposes when he comes to make out his tax return. The question of the assessment of such profits is therefore largely dependent on information reaching the Revenue authorities independently of the taxpayer — which must necessarily be a rather chancy affair. We feel that quite apart from any change in the present legal conception of taxable income, the hands of the Revenue would be greatly strengthened if there were a statutory obligation on taxpayers to return all profits made in the year; non-taxable or capital profits being shown separately.

The minority argued that, given the high rates of personal income tax and the exclusion of capital profits from the tax base, there is a strong incentive to convert taxable income into tax-free capital gains. As the manoeuvre can be fairly easily accomplished, they noted that "the taxpayer finds that his taxable income, and therefore the size of his tax bill, is left in large measure to his own discretion, provided he is a man of property." Also, "the social cost of defects in the tax base is to be reckoned not only in terms of inequity between different taxpayers, but in distortions of normal economic behaviour." The two forms of such distortions are "the desire and pursuit of short-term speculative gains", which distorts the

allocation of savings between different forms of investment, and the free charging of expenses of all kinds that may not be directly required to earn profits.

In paragraph 34, the minority stated, "the tax exemption of the so-called capital profits of various kinds represents the most serious omission in our present system of income taxation". In paragraph 35, they said:

> The basic reason for the inclusion of capital gains in taxation is that capital gains increase a person's taxable capacity by increasing his power to spend or save; and since capital gains are not distributed among the different members of the taxpaying community in fair proportion to their taxable incomes but are concentrated in the hands of property owners (and particularly the owners of equity shares) their exclusion from the scope of taxation constitutes a serious discrimination in tax treatment in favour of a particular class of taxpayer. The manner in which capital gains (of certain kinds at any rate) augment the taxable capacity of the recipient, has been convincedly shown, in our view, in the memorandum by the Board.

In discussing other forms of capital receipts the minority agreed with the majority that such receipts (premiums on leases, receipts on account of the sale of terminable rights, receipts on the surrender of leases, etc.) represent "a commutation of the future income which the vendor would have received had he retained it" and are "capable of being described as anticipations of future income in the hand of the recipient and, as such, as partaking of the nature of income" but do not agree with the majority that "common fairness argues against [their] inclusion in the range of taxable income" merely on account of the fact that the receipt "is in substance the equivalent of the discounted income of several years." The minority agreed that full progressive rates could be unfair, and therefore recommended that they be taxed as capital gains.

The following is a summary of the principal recommendations of the minority that pertain to capital gains:

1. Capital gains of individuals should be subjected to income tax, but not to surtax. Capital gains of companies should be charged to corporation profits tax.

2. The tax should be charged on the net realized gains of the year, after deduction of net realized losses. When net realized losses exceed net gains, the difference should be carried forward against future gains.

3. No distinction is to be made between short- and long-term gains. The transfer of property through inheritance or inter vivos gifts or settlements should reckon as realization, the property being valued for the purpose by the same rules as are applicable to stamp duties.

4. Net unabsorbed capital losses shown by an estate at probate valuation should be credited against estate duty liabilities.

5. Net receipts from the sale of terminable rights (after deduction of any sum that may have been paid by the recipient for the acquisition of those rights) which are now exempt from tax should be subjected to income tax in an analogous manner to capital gains.

6. Gains arising on the sale of owner-occupied houses, to the extent of one residence for each taxpayer, should be exempt from the capital gains tax.

7. For the purpose of the first introduction of the tax assets purchased before the appointed day should, in the case of securities quoted on the stock exchange, be deemed to have been purchased at the middle price ruling on the appointed day; in the case of other assets, the

actual cost of acquisition should reckon as the purchase price, but the taxable gain should be reduced to that fraction of the total gain which the period between the appointed day and the date of realization bears to the total period of ownership.

8. For an initial period the tax should be limited to gains arising from the sale of businesses, securities of all kinds and real property, and there should be an exemption limit determined by administrative considerations.

FROM 1962 TO 1966

The main factor which distinguishes this second period from the first is the shift in emphasis from cases to legislation. The development of the scope of income subject to tax was until 1962 largely dependent upon the preparedness of the courts to accept certain relatively minor extensions of the concept of income within the framework of a statute which had remained virtually unchanged in this respect since 1842. Inland Revenue could only go so far in its efforts to persuade the courts to expand "income". Canada is still involved in that phase, as the Department of National Revenue cannot hope for more than limited success in its efforts to develop the concept of income from an adventure in the nature of trade, given the present legislation. Since 1962, however, the part to be played by the courts in the growth of "income" to suit modern circumstances in the United Kingdom has been replaced by intense legislative activity, and as a result the last four years have seen more dramatic changes in the fundamental approach to the taxation of capital gains in the United Kingdom than ever before. The first tentative inroad by the legislature was made in 1962 with the introduction of Case VII, and this was followed in 1965 with full scale legislation taxing capital gains. Case VII must now be read in the light of the 1965 Statute.

The traditional distinction between income and capital gains is still retained, but no longer is it regarded as one which provides immunity from tax to the capital gain. It is interesting to reflect that only a decade after the Final Report of the Royal Commission on the Taxation of Profits and Income, where the majority declined to recommend any expansion of income, or any alternative method of charging capital gains, the social, economic and political climate was such that the government felt constrained to introduce such legislation. It is not, however, to be taken to be a triumph of the views of the minority over those of the majority, for the Memorandum of Dissent wished to include all net accretions to economis power into income. Although Case VII was a start along these lines, the capital gains tax of 1965 is not any part of the income tax. While Case VII is one of the cases under Schedule D, and therefore an income source, the new capital gains tax is not part of the schedular system at all, but is a separate and distinct tax.

Although it was first denied in the debates in the House of Commons that Case VII was taxation of capital gains, and although government and other tax authorities first regarded it as a nominal enlargement of the income net, the recent official discussions of Case VII have recognized it as being a short-term capital gains tax. There were several official publications in 1965 and 1966 to explain the new tax, including the White Paper, "Taxation of Capital Gains" 18/, and the Board of Inland Revenue's "Capital Gains Tax 19/, and both these publications acknowledge Case VII to be a tax on a form of capital gain.

The 1962 legislation 20/ was a last ditch attempt to stay within the traditional schedular system and yet to expand the scope of tax. The other six cases of Schedule D were left unaltered, so that the problems of whether a transaction was an adventure in the nature of trade remained, and in fact

still remains. The addition of a seventh case rather than the amendment of any existing case ensured that the developed jurisprudence would continue to apply. Case VII deemed the profit from certain transactions completed within stipulated time periods to be taxable income irrespective of the question whether they were chargeable to tax under some other case. One effect was that profits from an isolated or casual transaction or realization not chargeable under Case I might be caught by Case VII. The taxpayer, however, would possibly prefer to be taxed under Case I because deductions under Case VII are restricted as to earned income relief and other matters.

Case VII, known as the "speculative gains tax", caused to be charged all gains, not being gains which accrue as profits of a trade, profession, vocation, office or employment, accruing to residents of the United Kingdom, from the acquisition and disposal of chargeable assets, without the benefit of earned income relief, but after deduction of allowable losses. The charge was not retroactive, save to a certain extent in respect of shares in land-owning companies. There was an important relieving provision that there would be no such tax in the case of land where the disposal was more than three years after acquisition, or in any other case where the disposal was more than six months after acquisition. Losses arising on a transaction that would have given rise to tax if a gain had been made could be set off against gains, and the excess could be carried forward. However, although losses from a trade could be set off against Case VII gains, Case VII losses could not be set off against other income.

"Chargeable assets" for Case VII included all forms of property, including commodities on a future market, currency and tangible movable property acquired for use in a trade or business and disposed of without

being put to such use. However, other tangible movable property, such as cars, pictures, furniture, jewellery, etc. were excluded. Also, owner-occupied main residences with (usually) up to one acre of land (if acquired to live in) and buildings, or parts thereof, and land ancillary thereto, if occupied and used for a trade, profession or vocation, and not acquired wholly or partly for realizing a gain on disposal, were not "chargeable assets". There were certain other exemptions for certain public buildings. Also, fixed machinery and plant used in trade and not acquired wholly or partly for realizing a gain on disposal were not "chargeable assets", nor were certain patent rights.

There were careful provisions to include into the charge acquisitions and disposals of interests in or rights over chargeable assets, and to give a real (market) value to the consideration when the transaction was not at arm's length, or involved a gift, or was by way of distribution by a company in respect of its shares, or in other similar cases.

In computing the gain the same procedure was to be used as was provided for purposes of Case I, as if the transaction was an adventure in the nature of trade. Expenses wholly and exclusively laid out for the purposes of the transaction were deductible. There were detailed provisions to cover associated transactions and multiple transactions.

An important provision was that concerned with the disposal of shares in a land-owning company. Gains accruing from the disposal of such shares, even if acquired before the date of introduction of Case VII, were taxed. The section was to nullify the use of the six-month period by converting a deal in land to a deal in shares of the land-owning company. Such a company was defined as one with land being at least one fifth of its assets,

and not dealing in land as its stock-in-trade. The shareholder to be taxed on disposal of his shares must, directly or indirectly, himself or with a connected person, have held 10 per cent of the shares in the company, which company must have been controlled by no more than 5 persons.

The initial reaction to the introduction of Case VII, as reflected on the stock market, was severe, but once the implications of the tax were appreciated, the reduction in trading appears to have been nominal. It must be borne in mind that the United Kingdom economy is not such as to foster the "penny mining stock" markets prevalent in Canada, where a six-month period could have a considerable effect. Certain independent authorities 21/ have expressed the opinion that Case VII was virtually useless in bringing into income any substantial proportion of the trading profits in securities and land prevalent in the United Kingdom since the late 1950's. Indeed, the effect may well be that gains brought into charge will always remain slight, while taxpayers will be able to accumulate useful loss carry-forwards. There is virtually no case-law experience to draw on, but it is anticipated that taxpayers will sometimes consider it an advantage to be taxed under Case I and will seek this as an alternative to Case VII when they cannot achieve complete exemption from Schedule D. The new case should not (and was not intended to) have any appreciable effect on the judicial approach to other cases. Some aspects of this initial attempt to tax capital gains show that there was a desire not to go too far too fast; the six-month period ensured a minimal effect on the security market and the three-year period for land was evidently a statutory codification of what had long been the rule of thumb used by Inland Revenue when determining whether to assess a gain on disposal of land within Case I. Also the transitional provisions were generous. An interesting point from the drafting aspect is that

"chargeable assets" were defined as an all-inclusive phrase, from which certain items were specifically excluded (with the surprising omission in the case of agricultural land). The alternative of listing assets as specifically chargeable is much more cumbersome, and such a method can leave gaps.

With the introduction of the capital gains tax in 1965 (and also because of the coincidental introduction of a corporations tax) the Case VII charge was amended. 22/ In particular, the following important changes were made:

1. A single time limit, applicable to all assets, was substituted for the existing time limits of three years and six months. This meant that the complicated provisions as to the disposal of shares in land-owning companies could be dispensed with.

2. The exemption for tangible movable property was repealed, but certain specific chattels were exempted, including private cars, foreign currency for private expenditure abroad, gifts of chargeable assets up to £100 a year, and gains realized on disposal of chattels for £1,000 or less (as in the capital gains tax).

3. The exemption for buildings, land, fixed plant and machinery, occupied and used for trade, was repealed, but relief was given by way of deferment of tax where the proceeds are reinvested in the business within twelve months (as in the capital gains tax).

4. Gains from certain government and government-guaranteed stocks were exempted.

5. Because of the introduction of the new corporation tax, short-term gains accruing to companies were exempted, and instead became chargeable to the corporation tax or, at 35 per cent, to the capital gains tax.

As a final commentary on Case VII, it should be kept in mind that gains within Case VII are subjected to the graduated rates of the income tax and to surtax and could, in certain circumstances, result in harsher treatment than the flat rate capital gains tax. The capital gains tax is in no way intended to replace Case VII. In fact, some of the amendments to Case VII in 1965 would appear to be inroads upon gains which might otherwise have been caught by the capital gains tax (e.g., the extension from six months to one year of the basic time limit).

Turning now to the capital gains tax, this was imposed by Part III of the 1965 Finance Act, and applies where assets were disposed of after April 6, 1965, however long they may have been owned by the disposer. It does not apply if Case VII applies, or where any other income tax provision (e.g., Case I) brings the gain into chargeable income. The tax is not retroactive, so that any gain on disposal is only to be measured from April 6, 1965. Where the asset is not a quoted security or land with development value, there is an apportionment formula to establish what portion of a gain (or loss) in respect of an asset acquired before April 6, 1965 is chargeable. The tax is imposed on those resident or ordinarily resident in the United Kingdom, but not on charities, approved superannuation funds and other special bodies. The same scheme was used here as was used in Case VII, in that, instead of listing chargeable assets, all assets are within the scope of the charge, save where specifically exempted.

The main exceptions from chargeable assets are a principal owner-occupied residence 23/ with one residence of a dependent relative, chattels worth not more than £1,000, 24/ life assurance policies on surrender or maturity, foreign currency for private use abroad, savings certificates, premium bonds, defence bonds, national development bonds, betting wins, annuities, compensation for personal injury, private cars, works of art and objects of national, scientific, historical and artistic interest if not sold except to a national institution, university or local authority, gifts or bequests of land and buildings to the National Trust, and gifts of assets up to £100 per donor per year. Transfers between spouses are not taxed, but on subsequent disposal the gain or loss referable to the whole period of their ownership is taken into account. A similar treatment is accorded to transfers between companies which are members of a group.

The rate is 30 per cent for individuals, and for companies gains are included in their profits for corporation tax, which for the 1965-66 year was 35 per cent. Losses are computed in the same way as gains, and unrelieved losses may be carried forward without time limit. Unrelieved losses at death can be set off against gains of the last three years. However, losses cannot be set off against income, including Case VII income. The definition of "disposal" includes sales, leases, gifts, destruction (e.g., insurance compensation) and death, but in respect of death there is a £5,000 exemption. The capital gains tax is a deduction for estate duty purposes. Trustees are liable to the tax, both when investments are changed and when a limited interest ceases. There is a special provision to charge unrealized gains every fifteen years in a discretionary trust, and other special provisions include a sliding scale of deductible expenditures for wasting assets with a life of less than fifty years.

One of the areas of difficulty appears to have been to fit the new tax to the old scheme so as not to cause inequities. Thus it was necessary to have a provision whereby, as an alternative to the 30 per cent rate, the tax would be measured as the amount of additional income tax (and, where appropriate, surtax) a person would have to pay if half of the first £5,000 of his net gains, together with any excess over £5,000, had been treated as unearned income and added to total income. The usual procedure here is to aggregate the incomes of husband and wife. (Normally, gains and losses of husband and wife are calculated separately.) This provision will usually benefit those whose top rate is less than 60 per cent. However, further provisions prevent exploitation of the alternative base by arranging for gains to accrue to "connected persons".

Another area which quite expectedly required careful treatment was the computation of gains. Only the costs and incidental costs of acquisition or provision of the asset, plus expenditures wholly and exclusively incurred to enhance its value (if such enhancement was reflected in the state of the asset on disposal) or to defend the owner's title to the asset, plus costs incidental to disposal, can be deducted in computing the gain. Also, any amounts chargeable as a receipt in calculating income tax or corporation tax is excluded. Similarly, expenditures allowable in calculating those taxes, or covered by capital allowances, are not deductible.

There are very detailed provisions dealing with disposal of assets. Apart from the natural meaning of disposal, that is, whenever ownership changes or the owner divests himself of his rights in, or interests over, an asset by sale, exchange or gift, the Act has to deal with other occasions. Nowhere is "disposal" defined in the Act, but the concept is extended specifically to cover part-disposal, disposal when a capital sum is derived

from an asset (e.g., when a shareholder receives a capital distribution) deemed disposal on death, and deemed disposal by trustees of settled property.

Special provisions also had to be made for trusts— always an entity which causes tax problems. To avoid double taxation of capital gains in the hands of investment trusts and unit trusts and then again in the hands of the shareholders or unit-holders, the individual receives an annual notice showing his proportion of net realized gains in the trust after tax. On disposal of the shares or units, the individual may deduct his share of those net gains as a deduction in calculating his gains. Other trustees are liable to the tax on realization of the investments, or when a limited interest ceases, but in the latter case, not more than once every fifteen years.

To deal with the undue effect the tax might have on the disposal of business assets, relief is provided for land and buildings, fixed plant and machinery, ships and aircraft, and goodwill where the proceeds of sale are wholly reinvested in a new asset of the same class for use in the business within twelve months, or such extended time as the Board of Inland Revenue will allow. No tax is then chargeable, but instead, the price at which the new asset is acquired is deemed to be reduced by the amount of the gain so that, in effect, the tax is deferred until the replacement asset (or its replacement) is sold without being replaced. Tax is then chargeable on the total net gains from the assets in the series.

Special provisions are also made for the disposal of a family business on retirement. Gains on "chargeable business assets" of up to £10,000 are exempt, provided that the proprietor owned the business for ten years, or the company was a family trading company for ten years, and

the disposer was a full-time working director thereof. He must be sixty-five on retirement, and the £10,000 exemption is reduced evenly down to nil if he is sixty, by reductions of £2,000 per year or a proportion thereof for each part of a year. However many businesses he may have had, he only gets one exemption. Also the exemption is tied into the £5,000 death exemption, so that the two together cannot exceed £10,000.

In the absence of any realistic period of experience to test the success of the U.K. capital gains tax, it would not be suitable or prudent to attempt any assessment here. The decision to treat the tax on capital gains as separate and distinct from that on income, instead of expanding the concept of "income" to include all net accretions to economic power between two points of time, is one which follows the United States treatment, and that of many other countries. It will probably be a long time before the question of the relative advantages of these two alternative methods of treatment are finally resolved.

REFERENCES

1/ European Taxation no. 17, p. 3; Amsterdam, 1961.

2/ For comprehensive analyses of this period, see Perry, J. M., Capital Gains - The British Point of View, Canadian Tax Journal, Vol. 1 No. 6 Nov.-Dec. 1953, pp. 548-552; Seltzer, L. H., The Nature and Tax Treatment of Capital Gains and Losses, particularly Chapter 2, "Origins of the Special Legal Status of Capital Gains", pp. 26-27; National Bureau of Economic Research, 1951.

3/ Typical of this approach is that Adam Smith, when writing his "Wealth of Nations" in 1828, meant, by "wealth", "annual produce of land and labour".

4/ Jones v. Leeming [1930] A.C. 415 (H.L.); 99 L.J.K.B. 318; sub nom. Leeming v. Jones 15 T.C. 355.

5/ 15 & 16 Geo. 6 & I. Eliz. 2, c. 10.

6/ The word "employment" in both places in sub-paragraph (a), the words "Schedule A" in sub-paragraph (b) and the words "office, employment or" in the proviso to paragraph I have since been removed by amendments in 1956 and 1963.

7/ The words "Schedule A" in Case VI have since been removed by amendment in 1963.

8/ See, supra, reference 3/.

9/ Royal Commission on the Income Tax, (1920) Cmd. 615 and Royal Commission on the Taxation of Profits and Income, Final Report (1955) Cmd. 9474. The difference in the title of the second Commission is itself an indication of the broader scope of the inquiry.

10/ Royal Commission on the Income Tax, (1920) Cmd. 615.

11/ [1923] 2 K.B. 447; 8 T.C. 521.

12/ [1922] 1 K.B. 347; 8 T.C. 167.

13/ [1920] 252 U.S. Rep. 189.

14/ M.N.R. v. Taylor [1956] C.T.C. 189 at 199; 56 DTC 1125 at 1131.

15/ Cmd. 5131 - 5132.

16/ Volume 1, Replacement 1964-65, Butterworth & Co., p. 307.

17/ Jones v. Leeming, see, supra, reference 3/.

18/ H. M. Stationery Office (1965) Cmd. 2645.

19/ Board of Inland Revenue, No. 560 (1966).

20/ *The Finance Act*, 1962 (10 & 11 Eliz. 2, c. 44) Chapter II.

21/ Discussions were held with A. R. Illersic and P. F. Hughes.

22/ *The Finance Act* 1965, c. 25. Part II deals with Income Tax, and is divided into "General" (sections 9 to 16) and "Short-term capital gains" (sections 17 and 18) amending Case VII. Part III deals with capital gains (sections 19 to 45). Part IV deals with Taxation of companies and company distributions (sections 46 to 89).

23/ There are detailed rules to define "owner" and "occupier".

24/ The tax on disposal is not to exceed 50 per cent of the difference between £1,000 and the consideration; losses are restricted to the difference between the consideration and £1,000.

SECTION II

THE UNITED STATES

Introduction

A number of major proposals for amendments to the taxation of capital gains in the United States were made in the *President's 1963 Tax Message*. This was not the first time that amendments in that tax had been proposed by a United States President. As a matter requiring basic revision from time to time, the congressional record is filled with proposals, counter-proposals, bills, various revenue acts and other sundry official and semi-official statements dealing with capital gains and the effects of various taxes that have been levied on them in the past.

This part of the study will review the history of capital gains taxation in the United States. The main emphasis will be focused on the actual statutory provisions that have affected the subject over the years, particularly on those provisions that form the present law. These provisions, for the main part, were introduced in 1942, and were incorporated with only slight change into the *Internal Revenue Code* of 1954.

Falling outside the scope of this study are those legislative measures that have extended the preferential tax treatment accorded capital gains to items of income which, in the absence of such legislation, would be regarded as ordinary income (sale of patents, timber, coal and certain livestock). Also excluded are those exceptional code provisions dealing with property used in a trade or business, certain involuntary conversions, and so on. Similarly, the so-called non-recognition treatment

accorded to the gain and loss on the sale or exchange of some capital assets under certain conditions will not form a part of the following discussion. In addition, those special provisions relating to the sale of stock received from a corporation under circumstances indicating the existence of a "bail-out" or corporate reorganization will not be considered. These latter provisions, as well as a number of others contained in the Code, are not concerned with capital gains taxation as such. They are most properly regarded as anti-avoidance provisions which attempt to plug loopholes that are the product of a system that grants preferential tax treatment to some forms of income as opposed to others.

What remains after eliminating those provisions is really just those basic code provisions that deal with capital gains taxation. These provisions include those that deal with preferential rates, treatment of losses, percentage inclusions and capital loss carry-overs. It is not implied that by concentrating this study on the basic provisions that the complexities of capital gains legislation in the United States will be exposed. If anything, the reverse is true. The number of sections that deal peripherally with capital gains and losses far outweigh, both in number and in complexity, the basic provisions. For example, Subchapter O of Subtitle A of the Internal Revenue Code of 1954 (comprised of twelve sections and numerous subsections) deals with the problems of determining amounts of gain and loss, the recognition and non-recognition of gain and loss, the "basic rules", the provisions dealing with common non-taxable exchanges and the provisions dealing with "wash sales". Thus, the determination of when a transaction resulting in a taxable gain should be deemed to have taken place is of importance. For example, a disposition of property by bequest is specifically excluded from being a taxable transaction

(although the Treasury attempted to include in the 1964 amendments a provision removing this exemption) and the donee uses fair market value as the "cost" of the assets received—so that any accumulated but unrealized gain of the donor would be permanently free of tax. In addition the postponement of a realization for tax purposes is attractive because of the amount of tax deferment that could be involved. Thus United States taxpayers have been encouraged to defer a realization for tax purposes until such time as it was unavoidable. The attempts by taxpayers to change the ownership or form of assets without incurring an immediate tax liability, and the endeavours of the Treasury to protect the government revenues from such manoeuvers, have resulted in a number of the more complex sections of the Code and Regulations.

Similarly, Subchapter C of the same Subtitle contains numerous provisions respecting the capital gains ordinary income aspects of corporate distributions and adjustments. Subchapter C is composed of forty sections and, in the Commerce Clearing House, Inc., edition, dated August 1962, covers fifty-seven pages of exhaustive detail. All this is to be contrasted with what Stanley Surrey describes as the "complete treatment" of capital gains and losses which involves "only four short sections" of the code. These are the basic sections that will be considered here.

It is proposed to deal with the topic by dividing the discussion into three parts. The first section will deal with the history of capital gains legislation in the United States starting with the provisions in the Revenue Act of 1913 and extending up to, but not including, the Revenue Act of 1942. The discussion of the first period will be very brief and

will be confined pretty much to an analysis of the mechanical changes that were made. The reasons for these changes are available from various sources. A relatively concise summary is contained in an article by Anita Wells of the Division of Tax Research, United States Treasury, entitled Legislative History of the Treatment of Capital Gains under the Federal Income Tax, 1913-1948. 1/ It contains a well-documented analysis of not only the actual mechanical changes that were made in United States capital gains legislation but also discusses the reasons advanced for such changes.

This article may also be of use to the reader in analyzing the changes that were made in capital gains legislation in the period covered in the second section. That part will consider in detail the capital gains proposals and legislation that came into effect in 1942 and that were incorporated in almost unchanged form in the Internal Revenue Code of 1954. This section will carry the historical analysis through to, but not including, 1963. The last section will primarily deal with the President's proposals, made in January of 1963, for changes in the tax treatment of capital gains. Included by way of introduction to the 1963 proposals will be a brief resumé of some of the problems that are the product of the legislative approach as recorded in the first two sections. The last section will also review the actual amendments that were approved in the Internal Revenue Code for 1964.

A Summary of the Tax Treatment of Capital Gains from 1913-1942

Although the United States introduced their first income tax legislation in 1861, it was later repealed (effective 1872). In 1894 the income tax was reimposed in a comprehensive statute that specifically included all capital gains. However, on appeal to the courts this legislation was found to be unconstitutional.

Constitutional authority whereby Congress was empowered to "lay and collect taxes on incomes from whatever source derived, without apportionment among the several states, and without regard to any census or enumeration", was contained in the Sixteenth Amendment which became effective on February 25, 1913. The wording of this Constitutuional Amendment quite naturally gave rise to several important definitional problems. Among those problems was that of the meaning to be ascribed to the word "income". There were two facets to this definitional problem. In the first place, it was necessary to decide whether the word "income", as used in the Sixteenth Amendment, included gains on the sale or other disposition of capital assets, that is, capital gains. Assuming that such gains were to be included in the word "income" as used in the Amendment, it then became necessary as a matter of statutory interpretation to determine whether, under the various taxing statutes based on the constitutional authority of the Amendment, Congress intended to exercise its power to tax such gains.

In deciding the meaning of the word "income" in the Amendment, the United States Supreme Court in 1920 undertook to expound a definition of the word "income" itself. Thus it was stated: 2/

> Income may be defined as the gain derived from capital, from labour, or from both combined, provided it be understood to include profits gained through a sale or conversion of capital assets,....

In the following year, in a case arising under the Income Tax Act of 1916, the Supreme Court focused its attention on the meaning of the word "income" as used in the Act itself. In its examination the Court decided that the word had the same meaning under the 1916 Act that it had under the first income tax act following the Sixteenth Amendment—i.e., the Act of 1913. The Court also decided that the word "income" had the same meaning under these two Acts that it had under the

Corporation Excise Tax Act of 1909. Under that latter Act the Court determined, on the strength of the cases decided under it, that "income" included the casual gain on the sale of capital assets. Thus, having established the relationship between the Income Tax Act of 1913 and 1916 with the Act of 1909, the Court held that capital gains were to be charged to tax by virtue of that phrase in the Income Tax Act of 1916 which defined income to mean "gains or profits and income derived from any source whatever".

Therefore, the United States view of income for tax purposes has always been one that included gains from the disposal of capital assets. In fact, until 1922 (i.e., including the first United States taxing statute in 1861) identical treatment was accorded capital gains as for other forms of income. Although rates of income tax were increased substantially during World War I, it was not until 1922 that preferential treatment was first granted to long-term gains realized by individuals, and 1942 before corporations were accorded special rates. Therefore, recognition of the special nature of capital gains took the form of a reduction in the regular tax burden on an acknowledged form of income; it did not arise through the application of a new and relatively favourable tax on what hitherto had been considered non-taxable.

Thus, between 1913 and 1921 capital gains were subject to the same full rates of tax as were other items of income. During the same period the tax treatment accorded capital losses was subject to considerable variation. Up until 1916 no provision was made for the deduction of capital losses as such. The Revenue Act of 1916 provided for the deduction of capital losses but only to the extent that such losses did not exceed

capital gains. The 1918 Act loosened even further the restrictions against capital loss deduction by permitting a taxpayer to offset such losses fully against income of any kind.

Approximately coinciding with the Supreme Court decision referred to above, the Revenue Act of 1921 substantially altered the treatment accorded to capital gains and losses. That Act of 1921 was the first in which long-term capital gains were singled out for preferential tax treatment. The original proposal (passed by the House but not the Senate) was concerned with "extraordinary net income", which included compensation for personal services rendered during a period exceeding three years, and which contemplated an income-averaging scheme. However, the final legislation dealt only with "capital assets" (although some of the items considered to be "capital assets" for the purposes of the Code do not fall within the ordinary concept of this term). A major consideration for introducing preferential treatment of such gains was the hope that it might stimulate sales of appreciated property.

The introduction of preferential rates made necessary a definition of the type of gain that would qualify for such special treatment. Thus, for the first time, capital assets were given a statutory meaning. Under the 1921 legislation a taxpayer was given the privilege of separating his long-term gains from his short-term gains and paying a special flat-rate of 12.5 per cent in lieu of normal taxes. Long-term gains were those resulting from the realization of assets held in excess of two years. As originally enacted, the 1921 Act permitted the excess of long-term capital losses to be offset in full against other income. This anomaly was corrected shortly thereafter. Under the 1921 Act gains from short-term

transactions were to be included in other income and taxed accordingly, while short-term losses were to be allowed in full in computing income.

It is of interest to note that in 1921 the House and Senate were primarily interested in reducing the high rates of personal tax that were then applicable to all capital gains. The provision that the special treatment should apply only to long-term gains was introduced as an amendment from the Senate floor. This very important principle has, however, remained in the legislation ever since.

In the Revenue Act of 1924 provision was made to correct the anomaly whereby net long-term losses could be used in full to offset other income. The offset thereafter limited the amounts by which the tax could be reduced by such losses to 12.5 per cent. That percentage was the same flat rate established in 1921 for taxing long-term capital gains.

The Revenue Act of 1932 introduced legislation to counteract the flood of deductible losses stemming from the collapse of security prices. It was provided that short-term losses (those resulting from a transaction involving assets held less than two years) should only be allowed to the extent of short-term capital gains. A carry-over provision respecting net short-term capital losses, although enacted into law, was nullified by other legislation designed to promote economic recovery.

The Revenue Act of 1934 contained provisions which represented another major change in the thinking respecting capital gains and losses. In part, this change of thinking was a response to the allegation that the capital gains legislation encouraged the retention of capital assets for periods beyond two years when those assets had appreciated in value, while at the same time it encouraged the realization of short-term losses within the

two-year holding period. Both these situations, it was argued, were motivated largely by tax considerations. A solution was felt to lie in giving greater emphasis to the periods of time during which capital assets had been held prior to realization. The shorter the period of time the asset was held, the more analogous to ordinary income was the gain resulting from its disposition. The converse was felt to be equally true in establishing a true capital gain. In an attempt to relate the holding period more closely to true income or capital gains, the so-called "step-scale" plan for percentage inclusion of capital gains and losses was introduced. Under that plan the percentage of gain included in ordinary income ranged from a high of 100 per cent on an asset held for one year or less to 30 per cent on assets held for a period longer than ten years. Capital losses, taken into account on the same "step-scale" basis, were deductible only to the extent of recognized gains plus $2,000. This loss limitation applied equally to corporations and individuals. The "step-scale" plan for taxing gains did not, however, apply to corporations. In neither case was a limitation placed on the stated rate at which capital gains could be taxed.

A subcommittee of the House Ways and Means Committee was appointed in 1937 to review possible amendments to the Revenue Code. After devoting considerable effort to capital gains, they concluded:

> (1) capital gains represented taxpaying ability no less than equivalent income from other sources and repeal of the capital gains tax would increase the tax burden on other income;
>
> (2) the great bulk of capital gains are realized in connection with transactions entered into for profit; and
>
> (3) complete exemption of capital gains from income taxes would permit tax avoidance through conversion of other types of income into capital gains. 3/

The subcommittee considered the major complaint raised against the then current method of taxing capital gains—that it inhibited security transactions and aggravated stock market fluctuations—and concluded "that the available evidence and analysis did not support the charge that the capital gains tax interfered with transactions and accentuated booms and collapses". 4/ However, the subcommittee stated "that whatever effect the capital gains tax had on the capital markets was accentuated by the wide spread in the step-down percentages of the existing law", 5/ and they therefore recommended a monthly step-down in inclusion rates—100 per cent for the first year held, less 2 per cent for each month held in the second year, and less 1 per cent for each subsequent month held, until an inclusion percentage of 40 per cent would be reached at the end of the fifth year.

Although the House accepted the subcommittee recommendations, the Senate found the multiple holding period approach too complex. Therefore the Revenue Act of 1938 in effect became an amalgamation of the two preceding systems, incorporating both holding periods (three) and an alternative tax. Also, in cases of capital losses, only a flat-rate reduction in tax was allowed. As finally enacted, the legislation provided that capital gains and losses should be divided into two categories (i.e., short-term and long-term). Short-term gains and losses were those resulting from sales and exchanges taking place within eighteen months of acquisition. Net short-term gains would be added to ordinary income and taxed at full rates; net losses of a similar type could not be applied against ordinary income nor long-term gains, but could be carried over for one year to be applied against short-term capital gains of such subsequent year. The 1938 legislation divided long-term transactions in capital assets into two additional categories. The first category encompassed gains and losses on the sale of assets held for

a period of more than eighteen months but not over twenty-four months. Net gains of this type were regarded as income for tax purposes only to the extent of 66-2/3 per cent thereof and, in addition, were subject to a maximum stated tax rate of 30 per cent (thus, in effect, were subject to an effective rate of 20 per cent). The second category of long-term capital gains encompassed gains from a sale or exchange of assets held for a period in excess of two years. In this case the net amount included in income was only 50 per cent, and the maximum stated rate of tax was also 30 per cent (or an effective rate of 15 per cent). Net losses on both types of long-term transactions were taken into account at similar percentages and were subject to the same flat-rate limitation as to the credit applicable against the tax otherwise payable.

The 1938 Act made no change with respect to the taxation of capital gains and losses of corporations. Gains were still to be included in net income and taxed at regular rates, while losses were limited to the amount of capital gains plus $2,000. The taxation of corporation capital gains and losses was, however, dealt with in the Revenue Act of 1939. Under this legislation a corporation was also required to divide its gains and losses into long-term and short-term ones. The holding period was set at eighteen months and in this respect duplicated the treatment accorded to individuals. The treatment of gains of each sort was not, however, altered. They were all still to be included in ordinary corporation income. It was only with respect to losses that the position was changed. Whereas losses were previously limited to the amount of capital gains, it was now provided that long-term capital losses should be fully deductible from income. Short-term losses, however, could only be offset against short-term gains, although there was provision for a one-year carry-over of excess short-term losses.

A Summary of the Tax Treatment of Capital Gains from 1942-1963

In its final form the 1942 revision in capital gains legislation retained many features of the prior law. For example, there was a percentage inclusion of long-term gains and losses and a maximum tax rate limitation for long-term gains. Both the House Ways and Means Committee and Senate Finance Committee Reports indicate that the committee members believed that there were two very important basic principles that would, to a large extent, determine the effectiveness of a tax on capital gains. These principles were, first, that too high a capital gains tax would probably result in a loss of revenue to the government since owners would be reluctant to realize their gains. Similarly, a too high rate would stifle investment in new and productive enterprises. The second principle concerned the issue of whether it was realistic to continue to make the distinction between long- and short-term gains for the purpose of distinguishing between ordinary income and that type of income that was entitled, for various reasons, to preferential treatment. A supplementary question, assuming the continuance of the short- and long-term distinction, was where to draw the line in making that distinction, i.e., at what point or points in time the line should be drawn. The treatment of losses was also discussed. The controversy here was whether, in allowing losses partially or completely to be offset against ordinary income, taxpayers would be encouraged to realize their losses and thus to reduce their tax liability.

In its final form the 1942 Act raised the maximum tax rate on capital gains from 15 per cent or 20 per cent to 25 per cent. Justification for the increase was related to the over-all increase in individual rates brought about by the necessity of financing the war. Such an increase, it was felt, would not retard capital transactions.

A substantial conflict developed between the House and Senate Committees with respect to the related questions of treating capital gains differently from other income and of establishing a holding period. There seemed to be general agreement that certain types of capital receipts should be treated differently from ordinary income, so that the major difference between the congressional committees resolved itself into the question of the holding period. Three significant views were advocated. The United States Treasury, in advocating the abolition of the dual-bracket long-term capital gains and single-bracket short-term gains provisions of the 1938 law, suggested that there be only two brackets instead of three. All sales and exchanges within eighteen months of acquisition, it was said, should be accorded ordinary income treatment, while gains from transactions in assets held longer than eighteen months should also be included in ordinary income but only to the extent of 50 per cent of the gain. The simplification and shortening of the holding period could be expected to reduce the influence of tax considerations on the timing of sales. The House Committee agreed with the Treasury proposal but recommended that the holding period be reduced to fifteen months.

The Senate Committee, however, was prepared to recommend a much more drastic reduction in establishing the dual-bracket treatment of capital gains and losses. That Committee took the position that, since realization is really a matter within the taxpayer's discretion, the greater the reduction in the holding period the greater would be the inducement to transfer property. The Treasury would supposedly benefit by increased revenue. In the Senate Committee's view six months was an adequate time to distinguish between the investor and the speculator and, furthermore, the reduction to six months would presumedly not encourage speculation. The Senate Committee's recommendation was finally accepted.

The House and Senate Committee were in agreement on the treatment that should be accorded to individuals' capital losses. The provisions which allowed some capital losses to be offset against ordinary income were generally regarded as improperly stimulating such losses, with a consequent reduction in taxes. The result was the introduction of another statutory framework for the treatment of losses. Under this system all losses (both short- and long-term) were to be aggregated and then allowed as deductions only to the extent of the aggregate of short- and long-term capital gains. An excess of capital losses over gains was to be allowed, to the extent of $1,000, as an offset against ordinary income in the year of realization. A further relief against the limitation applicable to excess capital losses provided for their carry-over into five subsequent taxable years. Under the carry-over provision, the excess loss of one year could be applied not only against gains in those years but also against a maximum of $1,000 of ordinary income. A five-year carry-forward period was felt to be as long as was administratively feasible.

With respect to corporations, the Act provided that long-term losses of corporations could no longer be applied against ordinary income. Previously only short-term losses were not deductible from ordinary income. Instead, total capital losses were to be allowed as an offset against aggregate capital gains, with any excess loss of a corporation to be carried forward for five years as a short-term loss. A net long-term capital gain, as in the case of individuals, was to be taxed at a maximum rate of 25 per cent the first time corporations were allowed a preferential rate of tax on such gains. Net short-term gains were to be included in ordinary income and taxed at normal corporate rates.

Although there were no radical changes in the legislation after 1942, there were a few proposals made and some legislation enacted that is worthy of attention. For example, in 1950 the House Ways and Means Committee suggested that the holding period should be reduced from six to three months. The Committee reasoned that, since the purpose of the holding period was to distinguish between the investor and the speculator, six months was longer than necessary. Long holding periods were said to have disturbing effects on market prices and to stimulate inflationary pressures. The three-month proposal, however, was never enacted into law.

The Revenue Act of 1951 contained a provision whose purpose it was to correct a defect in the law respecting capital losses. Under the then existing law 50 per cent of a long-term capital gain or loss was excluded from the computation of net capital gain, net capital loss and net income. A short-term capital loss, however, was included to the extent of 100 per cent in the calculation. The result was that a $1,000 short-term loss could wipe out a $2,000 long-term gain. The solution to the problem was to require that 100 per cent of a long-term gain be included in gross income and that a deduction would then be allowed of 50 per cent of the amount by which the net long-term gain exceeded any net short-term loss. Thus, short-term losses would offset long-term gains on a dollar-for-dollar basis.

Another development in 1951 indicated the possibility of some additional changes in the basic capital gains legislation. In that year the United States Treasury Department prepared a tax study on the Federal Income Tax Treatment of Capital Gains and Losses. The suggestion of a revision was contained in the preface. However, no major changes in the law respecting capital gains were made in that year, nor in subsequent years,

until 1964. In their reports on the Internal Revenue Code of 1954 the House and Senate Committees both stated that no basic changes in capital gains legislation were being proposed.

The 1963 Proposals and Subsequent Legislative Amendments

In 1959, when referring to the system of taxing capital gains and losses in the United States, Stanley S. Surrey, at that time Professor of Law at Harvard University (now Assistant Secretary of the United States Treasury), wrote:

> ...the complexities caused by the treatment of capital gains and losses far outweigh the values which it is asserted are served by that treatment. Moreover, the present congressional approach to the definition of capital gains and losses inevitably results in more and more complexity so that the difficulties can only grow worse. 6/

In reading the above quotation it should be borne in mind that Mr. Surrey was not criticizing the inclusion of capital gains in the definition of taxable income. In a later portion of the same article from which this quotation was extracted, he pointed out that the basic treatment of capital gains for tax purposes is included in just four short sections of the Internal Revenue Code. These are the sections that deal with the alternative tax on capital gains, the deduction from income of half of long-term capital gains, the limitation on the deduction of capital losses, and the capital loss carry-over. Mr. Surrey's criticism was directed then, not to the inclusion of capital gains within the tax structure, but to the absence of any all-embracing definition that described what a capital gain or loss is for tax purposes. In the absence of such a definition, the author proceeded to expose the almost unbelievable vagueness that is the product of forty-two years of legislative attempts to deal with the definitional problem.

The main difficulties were seen by Mr. Surrey to stem from seven major problem areas that, under current statutory conditions, have a perpetually adverse effect on the taxation of capital gains. These problem areas are:

(1) the definition of "capital asset";

(2) the problem of distinguishing investment from business;

(3) the problem of distinguishing investment from speculation;

(4) the problem of distinguishing investment profits from rewards for personal effort;

(5) the problem of classifying transactions involving recurring receipts;

(6) the transformation of tangible assets into intangible property rights to those assets; and

(7) the transformation of ordinary income into stock appreciation.

He said that these seven problem areas would continue to affect adversely capital gains taxation so long as the following four conditions continue to exist.

(1) Preferential treatment is given to "capital gains", either through exemption, a preferential rate or (less serious) permission to average those gains, while other items of income may not be averaged.

(2) The rate schedule of non-capital gains is of such steepness that it makes the preferential treatment of capital gains significantly advantageous.

(3) The definitional approach to the content of "capital gain" follows the refined and intricate character of the present United States Code.

(4) Congress grants relief from high rates of tax by bestowing "capital gain" status on those taxpayers who are successful in pressing their claims for a tax reduction limited to their situation.

It is against the background of Surrey's succinct statement of how the legislation described above has been weakened by the failure to solve the basic problems, that the President's 1963 proposals should be viewed. It becomes apparent that these problems are the basis of some of the proposals.

In addition to proposing substantial changes in the definition of what constitutes a capital gain for tax purposes, the 1963 Revenue Bill also contained important but less dramatic changes in the tax structure. These latter changes are to a great extent related to other measures included in the 1963 Bill. The most important other measure was the overall plan for reducing tax rates. Individual rates had progressed from a low of 20 per cent to a high of 91 per cent. The proposed legislation called for a low rate of 14 per cent and a high rate of 65 per cent. It was proposed that the corporate rates of 30 per cent on the first $25,000 of taxable income and 52 per cent on the excess should be gradually replaced by a new minimum rate of 22 per cent on the first $30,000 of income and of 47 per cent on the excess.

With respect to individuals, it was proposed that the percentage of long-term gains to be included in taxable income should be reduced from 50 per cent to 30 per cent. When combined with the previously described general rate reduction, the effective rate of tax on long-term capital gains would then range from a low of 4.2 per cent to a high of 19.5 per cent.

The necessity of an alternative tax limiting the total tax on capital gains to no more than 25 per cent of such gain would be eliminated, and all individuals would therefore be subject to progressive rates of taxation on all of their capital gains. No changes respecting the capital losses of individuals, except for the carry-over provision, were proposed. Before net short-term losses could be used to offset net long-term gains, or net long-term losses used to offset net short-term gains, short-term capital losses would still be used to offset short-term capital gains, and long-term capital losses would still be used to offset long-term capital gains. The proposal eliminated the five-year limitation on the capital loss carry-forward, but left unchanged the annual allowed deduction from other income of $1,000. Any net capital loss could be carried forward to the next year and included in its category as a short-term or long-term capital loss. The loss would then be treated in the same manner as any short- or long-term loss sustained in that year.

It was also proposed that the holding period required to qualify for long-term gain treatment should be extended to one year (from the six-month period then applicable). This provision would apply to both individuals and corporations. It is useful to review the explanation given for this proposal by the President. 7/

> Preferential capital gains treatment with respect to gains on assets held less than 1 year cannot be justified either in terms of long-run economic objectives or equity. Moreover, the present 6 months' test makes it relatively easy to convert various types of what is actually ordinary income into capital gains. This proposal will provide far greater assurance that capital gains treatment is confined to bona fide investors rather than short-term speculators. The new lower rates of ordinary income tax, which will apply to gains realized on holdings of less than 6 months as well as 6 months to 1 year, will mitigate the reduced rate of turnover of securities and other assets that might otherwise result.

Probably the most critical element in the "package" of proposed capital gains reforms was the proposal that there should be a deemed realization of capital assets "at the time of transfer at death or by gift". The need for this amendment was emphasized in the comment that "certainly in its absence there would be no justification for any reduction of present capital gain rate schedules." 8/ Certain exemptions were included to limit the effect to less "than 3 per cent of those who die each year". Household and personal effects, transfers to the surviving spouse, and a minimum amount of gain ($15,000) were to be exempt, although the original cost basis would apply to subsequent dispositions by the spouse. Also, a special averaging provision was to be included that would limit the tax liability to five times the tax on one fifth of the gain, and a special carry-back provision would ensure utilization of all accumulated but unclaimed losses.

The unsatisfactory state of the definitional aspect of capital gains was also the subject of suggested improvements. The President commented:

> The existing sprawling scope of this preferential treatment has led to serious economic distortions and has encouraged tax avoidance maneuvers sometimes characterized as the "capital gains rout". 9/

Proposals were therefore made concerning real estate tax shelters, stock options, mineral interests, timber income, lump sum pension and profit-sharing distributions, livestock, citrus groves (and similar farm property), patents, royalties, instalment sales and life estates.

The 1963 proposals retained the basic structure of capital gains taxation for corporations. In line with the reduction in the general corporate tax rate it was provided that the alternative rate should be

reduced to 22 per cent from 25 per cent. The result of this proposal would have been to simplify the tax structures by reason of the replacement of the three former tax rates by a two-rate system. Some of the definitional changes mentioned above would also have affected corporations.

Although the general tax rate was reduced, very few of the suggested amendments to the taxation of capital gains received approval. The legislature was unwilling to deem that a disposition of capital assets would occur on gift or death, and the administration would not support a reduction in the effective rates of tax payable on capital gains unless the rest of the package of proposals was also assented to. However, the five-year limitation on the loss carry-over was removed, and some of the suggested changes in the definition of a capital gain (depreciable real estate, stock options, and so on) were partially incorporated into the Code.

In addition to changes in the taxation of capital gains, there have been a number of changes in the types of income that qualify for the favourable capital gains treatment. Changes in United States tax law are primarily developed in the Legislature and are, therefore, subject to lobbying by interested parties. Also, although a taxpayer might hesitate to request tax-free status, there has apparently been little reluctance to plead that certain transactions need relief from the high income tax rates and should therefore receive capital gains treatment. As a result of these pressures, and also of the greatly increased complexity and volume of business transactions as a whole, the definition of capital gains has steadily become more complicated until it is now regarded as the greatest source of complexity in a tax code that is acknowledged to be one of the most complex the world has known. The following quotations give one assessment of the current situation:

> The income tax provisions of the 1954 Internal Revenue Code represent probably the most complex revenue law ever enacted in the fiscal history of any country. The subject singly responsible for the largest amount of complexity is the treatment of capital gains and losses. And the factor in that treatment which is accountable for the resulting complexity is the definition of capital gain and of capital loss. ... But if the complexity is to be kept within reasonable balance, we must at all times have an awareness of the factors responsible for each particular complication and the values which that complication serves, so that the two may constantly be compared and weighed. So viewed, the complexities caused by the treatment of capital gains and losses far outweigh the values which it is asserted are served by that treatment. Moreover, the present congressional approach to the definition of capital gains and losses inevitably results in more and more complexity, so that the difficulties can only grow worse.
>
> The treatment of capital gains and losses in itself is relatively simple. ... the complete treatment, and the statutory provisions in which it is expressed, come to no more than a readily acceptable amount of detail. In fact only four short sections are involved. It is only when attention is focused on one bit of detail—the fact that this treatment is applicable only to capital gains and capital losses—and only when the search begins for the definition of those capital gains and losses that we start to uncover the enormous complexity and confusion inherent in this treatment. 10/ [Emphasis added.]
>
> The point here is that, lacking an adequate definition of capital gain, Congress is gradually moving to dealing with particular assets one by one. In such an endeavour any possible concept is likely to be lost in the welter of lobbyists. 11/

When faced with one property classficiation problem, when one group of taxpayers had only losses and another group of taxpayers only gains, "Congress resolved it in an intensely practical fashion—such depreciable property would in effect be a capital asset for gain purposes but not a capital asset for loss purposes. 12/

However, one factor must be emphasized that is often ignored by commentators on the United States system—the United States law did not run into difficulty until 1922 when the United States first begain to tax some capital gains at less than full tax rates. The source of the problem,

therefore, is not that the United States has chosen to tax capital gains, but rather that they have decided that the full progressive rate scale should not apply to capital gains. The second, but ancillary, factor is that in the United States they have chosen to codify in great detail the necessary definitional and procedural requirements that accompany any tax preference.

The United States courts have therefore had to face essentially the same problem as the Canadian courts, although the starting point differs. The Canadian act taxes "income" and the questions is: "Is a certain gain income?" The United States Code also taxes "income" but the courts have found that virtually all gains are "income". Therefore, the definitional problem involves determining which income transactions are eligible for capital gains treatment. In section 1222 of the Code "capital gain" is defined in terms of "the sale or exchange of a capital asset". "Capital asset" is defined as "property held by the taxpayer (whether or not connected with his trade or business), but does not include...". As everything the taxpayer holds is "property", he is eligible for capital gains treatment unless prevented by one of the five exclusions (i.e., for stock-in-trade; depreciable assets; real estate used for business purposes; a copyright, literary, musical or artistic composition; and certain types of government securities). The key exclusion is for stock-in-trade and contains the words "property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business", and thus the United States courts face the same question as the Canadian courts of having to differentiate between a business or an investment. The United States Congress has made a number of changes in the law in an attempt to clarify the situation, albeit with little success, as indicated by the following quotations:

Under these decisions is there any escape from wild uncertainty? If the courts are to embark on a search for the reason why individuals or corporations buy stock or securities and to weigh whether an "investment" motive is overbalanced by some other motive, many a stock or security can become an ordinary asset but no one will be able to predict when the transformation will take place.

...They force the judicial action taken in reference to them because of the failure of Congress to face up realistically to the tremendous classification problem inherent in the attempted division between "investment" and "business". Put more narrowly, the decisions represent the courts' view that Congress has not realistically faced that problem and, therefore, did not desire to be taken literally when it used the broad term "property" in section 1221. The courts are willing to rescue Congress from its statutory straight-jacket.

This approach simply turns property from an all-inclusive term into an elastic concept, contracting or expanding according to the courts' judgment of what a capital gain should be.

...Congress has in the most general way sought distinctions between "business" and "speculation" on the one hand and "investment" on the other. But its own concepts are unclear and it is beginning to appreciate that these terms do not have the settled significance in the world of economics or commerce necessry to support statutory differentiation. Hence, a piecemeal approach is developing and we are being led into a maze of complexity.

...One can only conclude that the exclusion regarding authors and other creative artists does evidence the basic congressional concept that the rewards for personal efforts should be outside the capital gain area, but that significant pressures can often turn aside the application of that concept.

This illustrates the tremendous difficulties inherent in the attempt to classify property between capital and noncapital assets under a complex legal structure which offers many patterns of property ownership. Such a legal structure, by permitting a tangible piece of property in effect to proliferate itself into various types of intangible assets, each in itself a form of "property", dooms any tax classification under the present definitional approach, if possible at all, to extremely intricate and detailed solutions. Moreover, the fact that it has taken us over 30 years to perceive these structural problems underscores the difficulties of definition in the capital gain field.

The result has been a snowballing accumulation of complex and intricate provisions in the tax law which, not solving our present difficulties, can only promise still greater complexity if the present approach is continued. 13/

Thus, it becomes obvious that, although a tax on capital gains may reduce the rewards for avoidance, any substantial tax preference for capital gains will involve complex problems in the Act and in the courts as the taxpayer and the administration each attempt to adopt an interpretation favourable to his own position.

It is also of interest to examine briefly the United States approach to stock market gains. They have had to face the problem of distinguishing between investment and speculation—having from the beginning acknowledged that some purchasers of securities actually contemplate the possibility of an increment in share value. Basically, Congress appears to have considered three main groups: investors, speculators, and security dealers. The latter are regarded as being in the business of turning over their inventories and are therefore generally denied capital gains treatment, with the exception that the Code (section 1236) permits designation of certain securities as investments so that they then become capital assets. The investor is regarded as a capital-gain taxpayer and, speculators as not deserving preferential treatment. For want of any better method of differentiation between the latter two, a holding period was introduced. The holding period (now six months) is not only indiscriminate in its uniform treatment of varying groups of taxpayers (professional speculator, amateur speculator, "trading" investor, and the very long-term investor) but also in effect extends preferential treatment to virtually all gains because the time period is so short and the available market techniques (despite many complex preventative sections) generally permit the informed investor to "protect" any gain while waiting for the time period to elapse. Thus, all but the day-to-day stock traders receive preferential treatment while their counterparts who deal in real estate are generally taxed in full as they are deemed to be in business.

Extract from the United States Revenue Act of 1913 [Emphasis added.]

SIXTY-THIRD CONGRESS. Sess. I. Ch. 16. 1913.

B. That, subject only to such exemptions and deductions as are hereinacter allowed, the net income of a taxable person shall include gains, profits, and income derived from salaries, wages, or compensation for personal service of whatever kind and in whatever form paid, or from professions, vocations, business, trade, commerce, or sales, or dealings in property, whether real or personal, growing out of the ownership or use of or interest in real or personal property, also from interest, rent, dividends, securities, or the transaction of any lawful business carried on for gain or profit, or gains or profits and income derived from any source whatever, including the income from but not the value of property acquired by gift, bequest, devise, or descent: Provided, That the proceeds of life insurance policies paid upon the death of the person insured or payments made by or credited to the insured, on life insurance, endowment, or annuity contracts, upon the return thereof to the insured at the maturity of the term mentioned in the contract, or upon surrender of contract, shall not be included as income.

That in computing net income for the purpose of the normal tax there shall be allowed as deductions: First, the necessary expenses actually paid in carrying on any business, not including personal, living, or family expenses; second, all interest paid within the year by a taxable person on indebtedness; third, all national, State, county, school, and municipal taxes paid within the year, not including those assessed against local benefits; fourth, losses actually sustained during the year, incurred in trade or arising from fires, storms, or shipwreck, and not compensated for by insurance or otherwise; fifth, debts due to the taxpayer actually ascertained to be worthless and charged off within the year; sixth, a reasonable allowance for the exhaustion, wear and tear of property arising out of its use or employment in the business, not to exceed, in the case of mines, 5 per centum of the gross value at the mine of the output for the year for which the computation is made, but no deduction shall be made for any amount of expense of restoring property or making good the exhaustion thereof for which an allowance is or has been made: Provided, That no deduction shall be allowed for any amount paid out for new buildings, permanent improvements, or betterments, made to increase the value of any property or estate; seventh, the amount received as dividends upon the stock or from the net earnings of any corporation, joint stock company, association, or insurance, company which is taxable upon its net income as hereinafter provided; eighth, the amount of income, the tax upon which has been paid or withheld for payment at the source of the income, under the provisions of this section, provided that whenever the tax upon the income of a person is required to be withheld and paid at the source as hereinafter required, if such annual income does not exceed the sum of $3,000 or is not fixed or certain, or is indefinite, or irregular as to amount or time of accrual, the same shall not be deducted in the personal return of such person.

Extracts from the United States Internal Revenue Code (1954), including 1962 Amendments

Subchapter B - Computation of Taxation Income

PART I - DEFINITION OF GROSS INCOME, ADJUSTED GROSS INCOME, AND TAXABLE INCOME

SEC. 61. GROSS INCOME DEFINED.

(a) General Definition -- Except as otherwise provided in this gross income means all income from whatever source derived, including (but not limited to) the following items:

(1) Compensation for services, including fees, commissions, and similar items;
(2) Gross income derived from business;
(3) Gains derived from dealings in property;
(4) Interest;
(5) Rents;
(6) Royalties;
(7) Dividends;
(8) Alimony and separate maintenance payments;
(9) Annuities;
(10) Income from life insurance and endowment contracts;
(11) Pensions;
(12) Income from discharge of indebtedness;
(13) Distributive share of partnership gross income;
(14) Income in respect of a decedent; and
(15) Income from an interest in an estate or trust.

Source: Sec. 22(a), 1939 Code, substantially unchanged.

(b) Cross References.-

For items specifically included in gross income, see Part II (sec. 71 and following). For items specifically excluded from gross income, see Part III (sec. 101 and following).

PART II - ITEMS SPECIFICALLY INCLUDED IN GROSS INCOME

Sec. 71. Alimony and separate maintenance payments.
Sec. 72. Annuities; certain proceeds of endowment and life insurance contracts.
Sec. 73. Services of child.
Sec. 74. Prizes and awards.
Sec. 75. Dealers in tax-exempt securities.
Sec. 76. Mortgages made or obligations issued by joint-stock land banks.
Sec. 77. Commodity credit loans.
Sec. 78. Dividends received from certain foreign corporations by domestic corporations choosing foreign tax credit.

PART III - ITEMS SPECIFICALLY EXCLUDED FROM GROSS INCOME

Sec. 101. Certain death benefits.
Sec. 102. Gifts and inheritances.
Sec. 103. Interest on certain governmental obligations.
Sec. 104. Compensation for injuries or sickness.
Sec. 105. Amounts received under accident and health plans.
Sec. 106. Contributions by employer to accident and health plans.
Sec. 107. Rental value of parsonages.
Sec. 108. Income from discharge of indebtedness.
Sec. 109. Improvements by lessee on lessor's property.
Sec. 110. Income taxes paid by lessee corporation.
Sec. 111. Recovery of bad debts, prior taxes, and delinquency amounts.
Sec. 112. Certain combat pay of members of the Armed Forces.
Sec. 113. Mustering-out payments for members of the Armed Forces.
Sec. 114. Sports programs conducted for the American National Red Cross.
Sec. 115. Income of States, municipalities, etc.
Sec. 116. Partial exclusion of dividends received by individuals.
Sec. 117. Scholarships and fellowship grants.
Sec. 118. Contributions to the capital of a corporation.
Sec. 119. Meals or lodging furnished for the convenience of the employee.
Sec. 121. Cross references to other Acts.

REFERENCES

1/ This article originally appeared in the National Tax Journal, 1949, Vol. II, No. 1.

2/ Eisner v. Macomber, 252 U. S. 189, 206-7 (1920).

3/ Anita Wells, "Legislative History of the Treatment of Capital Gains under the Federal Income Tax, 1913-1948", National Tax Journal, 1949, Vol. II, No. 1, p. 22.

4/ Ibid., p. 23.

5/ Ibid., p. 23.

6/ Stanley S. Surrey, "Definitional Problems in Capital Gains Taxation", Tax Revision Compendium, Vol. 2, p. 1203.

7/ The President's 1963 Tax Message, p. 20.

8/ Ibid.

9/ Ibid, p. 21.

10/ Stanley S. Surrey, "Definitional Problems in Capital Gains Taxation", Tax Revision Compendium, Vol. 2, pp. 1203-4.

11/ Ibid., p. 1210.

12/ Ibid., p. 1209.

13/ Ibid., pp. 1213-28.

SECTION III

THE TAXATION OF CAPITAL GAINS IN OTHER COUNTRIES

Unfortunately the reference material available on this subject is both sparse and conflicting. A brief review of the taxation of capital gains in some of the more important countries is given. Reports prepared for this Commission by the International Bureau of Fiscal Documentation and the Confederation of British Industry publication "Taxation in Western Europe 1966" have provided the basic source of information for the European countries.

AUSTRALIA

In Australia, income tax is levied on income derived by a resident from all sources.

Income is not defined, but profits from the sale of property acquired for profit making, or from carrying out any profit-making undertaking or scheme, are assessable.

Australian income tax law also provides that a contract, agreement or arrangement which has the effect of altering the incidence of, or avoiding any tax, or preventing the operation of the Act, is void for tax purposes.

The Report of the Australian Royal Commission on Income Tax (1955) did not deal with the taxation of capital gains in any detail.

NEW ZEALAND

In New Zealand, tax is levied on income from all sources derived by a resident.

The law contains no definition of income, but income of any kind not exempted from tax is "assessable income". Specifically included in income are the following:

(a) Profits and gains derived fron any business, including capital gains realized on stock in hand at the time of sale or transfer, and so on, of a business

(b) Profits from the sale or disposal of any real or personal property acquired for sale or disposal at a profit.

The Report of the New Zealand Royal Commission on Income Tax (1951) did not deal with the taxation of capital gains in any detail.

UNION OF SOUTH AFRICA

In South Africa, income tax is charged on income received by, or accrued to, or in favour of, any person from any source within the Union, or which is deemed to be within the Union. Included in income deemed to be derived from a source within the Union is income arising from any services rendered or work done in carrying on any trade in the Union. Trade is defined to include every profession, trade, business, employment, calling, occupation or venture.

In computing his taxable income, the South African taxpayer is allowed a specific exemption for all receipts of a "capital nature" which are not specifically to be included in that computation.

With respect to the taxation of capital gains the following statement is taken from the First Report of the Committee of Inquiry into the Income Tax Act.

> We appreciate that in many cases the decision as to whether upon the disposal of an asset, the proceeds accruing are of a revenue or a capital nature gives rise to much difficulty. The large number of cases which have come before the Courts for the determination of disputes upon this point is indicative of the difficulty of the problem. Various tests have been laid down by the Courts, one of the most important of which, where the accrual consists of the realized proceeds for an asset which has been disposed of, is the intention with which the asset was acquired. Thus where the asset can be established to have been acquired to produce an income in the form of rent or dividends and the disposal to have been the result of fortuitous circumstances, any gain resulting will be regarded as of a capital nature. On the other hand, where the object of the purchase was to obtain a profit by resale of the asset at an enhanced price then any gain resulting will be regarded as of a revenue nature. It will be apparent that the application of this test will involve consideration of all the circumstances surrounding the acquisition and the disposal and that many borderline cases will arise. That the problem is one that will occur frequently is also fully realized for it is one that arises in respect of all cases in which shares are bought and sold by taxpayers on the stock exchange. The number of cases in which this difficult question arises for decision must, therefore, be not inconsiderable. Notwithstanding these difficulties, however, we are of opinion that any attempt to extend the scope of the income tax in such a way as to bring capital gains within the net would so violate the fundamental concept of an income tax as to be unacceptable.
>
> We recommend unanimously, therefore, that the scope of the income tax be not extended to capital gains, and that the tax should continue to be imposed on any gain resulting from the disposal of assets only where, on an application of established tests, such gain is not of a capital nature. 1/

BELGIUM

In Belgium, capital gains on the sale of industrial and commercial property and securities by a corporation or an individual in business are taxable. The concept of business, although considered to be very broad, is not defined. To establish whether a taxpayer is in business it is necessary to determine if he deals regularly in certain assets, and also the frequency of his transactions. There must be a profit goal. Corporations and other entities established to produce income are deemed to be carrying on business.

Unrealized capital gains resulting from asset revaluation by businesses are included in income if and when such gains are reflected in the profit and loss account, or if and when they are deemed to be distributed.

Before 1962, capital gains of a business were taxed to individuals under progressive rates ranging up to 55 per cent and to corporations at the rate of approximately 30 per cent. The basis for determining the gain was the depreciated capital cost.

However, since 1962 a measure of relief from the taxes on both realized and unrealized capital gains arising in the course of a business has been granted in three ways. First, sole proprietors are exempt from tax on gains derived from the sale of land that had been used for business purposes. Corporations, traders or renters of property are only exempt for part of the capital gain, and then only when certain assets held for more than five years are sold or revalued. These assets are land, industrial and commercial buildings and equipment, and portfolio investments. The relief is obtained by applying an inflation coefficient (which is based on the price of gold) to the historical cost of the asset, and then by reducing this adjusted cost of the asset by the accumulated depreciation allowances to determine the "cost" for tax purposes. That part of the capital gain (if any) that must be included in income is subject to a flat-rate tax of 15 per cent. This flat rate is a benefit to corporations, but not to those few individuals whose marginal rate is under 15 per cent. Secondly, unrealized capital gains arising in the course of a business are generally exempt from tax. However, both this exemption and the relief described above do not apply if the gain is distributed or is allocated in any other way — such as to a legal reserve or to provide for a payment to directors, shareholders, or any other person.

There is also a reinvestment incentive in the case of proceeds resulting from damage to or loss of business assets if they are reinvested within three years, and special provisions apply to mergers and liquidations. Complete exemption is also extended to all business assets of a deceased individual if the business is subsequently carried on by his wife or heirs in the direct line.

The effect of the inflation adjustment is indicated by the coefficients listed below:

Date of Acquisition	Coefficients
1918 and before	16.33
1919	11.49
1920	6.15
1921	6.30
1922	6.43
1923	4.37
1924	3.89
1925	4.02
1926	2.72
1927 to 1934 inclusive	2.35
1935	1.86
1936 to 1943 inclusive	1.70
1944 to 1948 inclusive	1.14
1949	1.10
1950 and subsequent	1.00

Since 1962 individuals have become taxable on speculative gains not derived in the carrying out of a business. There is no definition of speculation in the legislation. Speculative losses are only deductible from speculative gains. In the case of unimproved real property held for less than eight years, the gain is taxed at special rates - 30 per cent if held for less than five years, 15 per cent if held for more than five but less than eight years.

DENMARK

A distinction is made between ordinary income and special income. The latter includes certain realized capital gains and losses which are not deemed to be ordinary business or speculative income, and certain other benefits that are not of a regular, recurring nature. An individual's ordinary income, which includes ordinary business or speculative income, is taxed at steeply progressive rates. Special income may either be spread evenly over three consecutive years and added to ordinary income, or it may be taxed at a flat rate of 30 per cent on the amount of the gain (after adjustments) in excess of an exemption of about $150. All of a corporation's income (ordinary and special) has since 1960 been taxed at a flat rate. Previously, the ordinary income of the corporation had been subject to progressive rates. Income tax paid on ordinary income of the previous year is deductible, the tax paid on special income is not deductible.

The concept of ordinary income is in general similar to that in Canada, except for a more specific inclusion of certain speculative profits, for a speculative purpose is *prima facie* assumed (unless proof to the contrary is given) if a sale takes place within two years of acquisition. Special income includes certain benefits related to employment (including "golden handshakes") as well as the following capital gains and losses:

(a) Gains and losses on the disposal of business machinery and equipment at liquidation.

(b) Gains (not losses) on the disposal of business premises to the extent of any special investment allowances previously claimed.

(c) Gains and losses on the disposal of business goodwill.

(d) Gains and losses on the disposal of non-perpetual rights such as patents, trademarks, designs, copyrights, etc.

(e) Gains and losses on the surrender of rights under a lease or lending contract.

(f) Gains and losses on the disposal of shares and other securities and rights to same.

(g) Gains and losses derived from liquidating distributions in the year of liquidation.

(h) Gains (not losses) on the disposal of immovable property (including business premises).

In all but (a) or (b) any gain or loss is ordinary income if the transaction is part of the taxpayer's trading activity, or if engaged in as a speculation.

The two most important sources of capital gain are subject to special treatment, apart from the provisions already detailed. Only two thirds of the profit or loss on share transactions is taken into account, thus reducing the effective rate of the flat-rate tax to 20 per cent. No allowance is made for inflationary profits.

Gains (not losses) on immovable property were first included in special income in 1962, and until the end of 1965 only gains on property acquired after 1948 were included. The purchase price is increased by an inflation adjustment declining from 128 per cent for property acquired in 1949 to 40 per cent for property acquired in 1960 and subsequent years. The first part of the profit remaining (about $750) was exempt. From January 1, 1966 on, the pre-1949 exclusion was dropped and the inflation adjustment became a flat 40 per cent plus 6 per cent for each year after 1965 that the

property is held. The balance of gain remaining after this computation is, for individuals, increased by 100 per cent and for corporations by 66-2/3 per cent. Thus, for individuals, the rate of tax on gains from immovable property is, in effect, limited to 60 per cent of that portion of the gain remaining after the inflation adjustment.

The aggregate of allowable special losses in any year (which does not include losses on immovable property) may be deducted from ordinary income. Profits from the sale of owner-occupied houses are generally exempt from tax.

FINLAND

As in Canada, gains derived in the ordinary course of business are treated as ordinary income. There is no definition of "business" or of "business income". Realized capital gains are included in total income and are taxed at ordinary rates if the asset concerned has been held less than ten years in the case of immovable property, or five years in the case of movable property. Capital losses are only deductible from capital gains.

FRANCE

In principle every business (of a corporation or of an individual) must include in taxable income all gains, including those of a capital nature. Individuals not in business are only taxable on gains arising from some transactions in land or on the disposal of shares in a company in which a major interest had been held. In practice, however, even business gains have been subject to many complex provisions applying to certain kinds of transactions and to certain holding periods that operate to reduce (sometimes to nil) the tax on such capital gains. Generally, the motivation for the provisions appears to be to encourage certain types of economic activity.

French jurisprudence is based upon a business test somewhat similar to the Canadian (regularity of activity, profit-seeking intent). Up until September 1, 1965, the taxpayer who was in business was eligible for various kinds of preferential treatment on gains from asset disposal.

(a) If the proceeds of disposition of a capital asset (not inventory) were reinvested in the pertinent enterprise in reinvestment assets as defined (generally capital goods such as plant, machinery, equipment, etc.) within three years, then immediate taxation was avoided. This was only a deferral, albeit permanent in many cases, as the new asset retained the cost base of the old. This provision was even available for isolated assets (those not forming a part of the enterprise as such, for example, temporary investments).

(b) In the case of partial or total liquidation, special rates of tax were applied to the gains. If the enterprise was acquired or created within the previous five years, in effect only half the gain was taken into income (and taxed at full rates). If over five years had elapsed, the tax was 6 per cent for individuals and 10 per cent for corporations on the full amount of the gain.

(c) The above reduced rate of tax did not apply to an individual who transferred his business to a partnership of which he was a member, or to a company whose only shareholders were the entrepreneur and his direct family. In this case, and also on death, if the direct family continued the business, the reinvestment provisions in effect were deemed to apply, the gain was free of tax and the original book value was retained.

(d) A corporation, in the case of a merger, received the same treatment as an individual in (c).

(e) Agricultural income of an individual included capital gains on transfer of business assets, except for land or buildings which were exempt. A company received no such exemption. However, the provision was immaterial for most individuals in agriculture as a farmer could elect to be taxed on a lump sum basis which ignored his real income and employed regional standards for different kinds of agriculture.

(f) To encourage house construction taxpayers in this business received special treatment. Before 1963 a corporation was free of tax on rental income (and capital gains) realized within twenty-five years of construction. Now (and at least until 1970) the corporation may apply the reinvestment exemption to gains on disposal of "qualified" dwellings. Individuals also qualify for this tax postponement device on business income.

However, since September 1, 1965, this approach to gains realized by a business has been substantially changed and long-term gains are to be treated differently from short-term gains. Short-term gains result when a business asset is transferred within two years of when it is acquired. Short-term losses also relate to assets held less than two years but also include losses realized on depreciable assets—regardless of the holding period. Short-term gains realized in the course of business are taxed at full rates (corporate or personal), although payment of the tax can be spread over five years. Long-term gains are generally taxed at a flat 10 per cent, regardless of whether they are reinvested. However, taxpayers subject to company tax

must pay the additional tax required to bring the total tax on the long-term gain up to the level of the company tax if they distribute the gain other than in winding up the company, or by adding it to share capital, or by using it to offset losses. Short-term losses are first offset against short-term gains of the same year and then may be deducted from ordinary income. Long-term capital losses are only deductible from long-term gains in the same year or during the subsequent ten years, except in the case of liquidation—when up to one fifth of the long-term capital losses can be deducted from ordinary income of that year.

In general, non-business capital gains by individuals are exempt from taxation. However, there are exceptions. A special tax of 8 per cent is applied to gains (exceeding an amount of about $200) on the disposition of shares in a corporation in which the taxpayer or a member of his direct family was, at any time in the previous five years, entitled to 25 per cent of the profits and has acted as a director. In addition, in 1962 a special tax of 25 per cent of the capital gain realized on the sale of land for building construction was introduced. This was replaced by a transitional measure applicable until the end of 1965, after which time any gain realized by an individual who built, or had built for him a building, would be subject to full personal rates of tax.

In the case of land (or shares representing such realty) deemed to be for the purpose of building construction, the gain is subject to full taxation at progressive rates, but the tax base is reduced by some rather complex adjustments. Land is deemed to be for building construction unless it can be proved that it will be used only for agriculture, that construction is forbidden by law, that the value is below stipulated limits, that the present building-to-land coverage exceeds 15 per cent and the value of

improvements exceed 30 per cent of the selling price (25 per cent in municipalities of over 200,000 inhabitants), or that the land is to be used for expansion of an industrial and commercial enterprise. The tax base is computed as follows:

> Selling price (SP); minus acquisition cost (AC) adjusted by development costs, or by a 25 per cent lump sum allowance, and by an allowance of 3 per cent of AC for each year (n) held, and by a revaluation coefficient (Y) based on year of acquisition (coefficients were established by the balance sheet revaluation decree of 1960 and range from 243 for 1917 to 1.05 for 1958).
>
> Therefore:
>
> $$\text{Capital gain} = SP - Y\left\{ AC + \frac{25AC}{100} + \frac{3n\left(\frac{125}{100}AC\right)}{100} \right\}$$
>
> Furthermore, if the total of the above gain for the year is under 50,000 Frs. (about $11,000) they are exempt. Partial exemption is extended to gains between 50,000 Frs. and 100,000 Frs. In addition, the net gain after any exemption is further reduced by stipulated percentages based on whether the property was acquired by inheritance or gift, or by other means. For the former the percentage is 50 per cent, for the latter 30 per cent. For years prior to 1968, these percentage exclusions are higher. Also the percentage is increased by 10 per cent if the vendor is a public body.
>
> If this computation results in a capital loss, it is not deductible.

The 1963 amendments also narrowed the scope of tax-free gains for individuals disposing of immovable property not covered by the above two provisions (i.e., actual construction of a building or land deemed to be used for construction). The number of exclusions in the section of the Code defining transactions deemed to be business activity was reduced. Also all such gains are to be taxable unless the seller can prove he acted without speculative intent. If the disposal occurs within five years of acquisition speculative intent is generally assumed except for a residence. Agricultural

land or woodland remains exempt. Full progressive rates apply, but the taxable gain is based on acquisition cost, plus development costs, plus 3 per cent of the acquisition cost and development cost for each year of ownership.

Non-residents are subject to a special tax on realty capital gains if a French resident would have been taxable on the same transaction. This tax, at 50 per cent of the gain, is paid on registration of the deed of transfer.

GERMANY

The taxable income of a business (of a corporation or of an individual) is the difference between the total assets of the enterprise at the end of an accounting period and its assets at the end of the previous accounting period. Withdrawals are then added to the resulting figure and capital contributions are subtracted therefrom. The valuation of assets and liabilities must be carried out in accordance with detailed valuation rules contained in the income tax legislation. Therefore, in general, capital gains are not distinguished from ordinary income and do not receive special treatment. However, preferential treatment is accorded in certain cases. Capital gains on agricultural real property are exempt. Gains from the forced sale of, or damage to, property are not taxed if reinvested. Gains from the sale of certain capital assets, which have been used in the business for at least six years, are also exempt if reinvested in specified assets within limited time periods. However, the gain must be deducted from the cost of the new assets for purposes of determining future depreciation. Mergers receive special treatment and the gain on a sale or discontinuance of a proprietorship or partnership (which is considered to be the last business transaction of the

owners) is subject to a reduced rate of tax of between 10 per cent and 30 per cent (the amount determined at the discretion of the finance department) if the gain exceeds a stipulated minimum. Capital losses are deducted in full in the current or subsequent five years.

Individuals in their personal capacities are only liable for tax on capital gains in two circumstances. First, the gains on the disposition of non-business real property (or rights to same) held for two years or less and on other property (including securities) held for six months or less, are taxed at normal rates. Short sales are also fully taxable. Gifts or bequests do not give rise to taxable gains. Losses are only deductible from these speculative gains in the same year. If the total of net speculative gains in a year are under an amount of about $250 they are not taxable. However, as shares are not regi tered, enforcement is impossible and, in fact, the taxation of these gains is not enforced. Secondly, the sale of a "substantial interest" in a corporation will result in a taxable capital gain. This taxable gain arises when an individual sells shares representing more than 1 per cent of the nominal share capital of a corporation in which he, or he and his family, control, or have controlled in the preceding five years, more than 25 per cent of the capital. The first portion (an amount of about $500) of such gains are exempt. Full credit against this tax is allowed for succession duties paid on the shares. Mergers receive special treatment. The rate of tax is identical to that applied to the gain on a sale or discontinuance of a proprietorship or partnership and is generally at half the ordinary progressive rates. Losses are not deductible.

ITALY

Individuals are subject to an over-all progressive tax on total income after deduction of the applicable schedular taxes paid on presumed income from

three kinds of realty (land, buildings and agricultural land), and on income from four categories of personalty and labour (A - personalty other than dividends, B - business, CI - profession, and CII - employment). Corporations pay a company tax (consisting of an excess profits tax and a net worth tax) on income after deduction of the above schedular taxes paid and of an amount equal to 6 per cent of net worth.

Category B of the schedular taxes applies to income from any business enterprise or activity and to speculative transactions unrelated to the business. There is no definition of a speculative gain. Revaluation gains and realized profits on the disposal of business assets are included, although in 1953 a tax-free revaluation was permitted for business assets that had been held for more than 6 years. Capital losses are deductible from ordinary income.

In general, capital gains realized on transfers of real or personal property, other than business assets, are not subject to tax. However, in 1963 a new tax was introduced on capital gains on unimproved land (to be used for construction purposes). The tax rate progresses from 15 per cent on the gain up to 30 per cent of the base value, to 50 per cent on the gain exceeding 500 per cent of the base value. Some adjustments are allowed in computing the base value from original cost.

THE NETHERLANDS

Company and individual taxes are imposed at full rates on the total aggregate gains of a business enterprise. The concept of business income is very broad. In particular, all gains realized by corporations, or to individuals in the ordinary course of his business or profession, are subject to

tax (even if they are of a capital nature). There is no realization of a taxable gain, however, when one asset is exchanged for another and the new asset performs the same function as the old. The non-realization feature also extends to cases of sale and replacement and to security sales by investment companies. In all cases the "cost" of the new asset will be the acquisition price less the capital gain on the old asset. Gains on agricultural real property were exempt, but the exemption has been abolished. Special provisions apply to mergers but not to liquidations.

In the case of a business carried on by an individual any gain on termination in excess of an amount of about $2,000 is taxable at progressive rates unless the taxpayer elects special treatment. If termination is by sale or liquidation, the special tax is 20 per cent to 40 per cent with the specific rate being equal to the individuals' three-year average marginal rate of tax before the gain. In the case of death or emigration, a sale is deemed to have occurred and the optional rate is available. An additional option is provided for heirs who carry on the business—of tax exemption if the previous book value of assets is carried forward, or of a flat 20 per cent tax.

Under a prior law a gain realized by an individual on a sale of real property held for less than two years, or of a security held for less than one year, was subject to tax. There was an exemption of approximately $150, and speculative losses were allowed only as a deduction from speculative gains. That law has been abolished. The former law with respect to the sale of a "substantial interest" has, however, been retained. Thus, any gain flowing from the sale of shares by a taxpayer who, either alone or with his spouse, had owned more than 7 per cent of the issued capital, and either alone

or with his close relatives had owned 33-1/3 per cent or more of the issued capital at any time during the previous five years, is taxable at a flat rate of 20 per cent. Otherwise an individual is not taxable on capital gains derived outside of a business.

SPAIN

Land and buildings located in urbanized territory are subject to local taxes on realized and unrealized increments in value. Realized gains are subject to various tax rates based on the length of the holding period up to a maximum of 25 per cent.

Corporations are taxable on realized capital gains. They are also taxed on unrealized gains reflected in the accounts if they are the basis of a profit distribution unless the gain is reinvested in similar assets, is deposited in a segregated bank account, or is invested in specified securities which are in turn deposited. Gains on mergers or liquidations are subject to the full corporate tax unless the merger or takeover is deemed to benefit the economy.

Individuals are subject to income tax on gains arising in the course of business or from the disposal of non-business assets (real property or securities) held for less than three years unless the proceeds are invested for at least three years in specified securities (of government projects). Certain other gains (e.g., sale of an entire business) may be taxable even if the holding period exceeds three years. Capital losses are only deductible from capital gains realized in the same year. There is no taxable realization in the case of gifts or bequests.

SWEDEN

Sweden employs a schedular system of taxing income, but each of the six categories of income have been so broadly construed that "every conceivable income is reached".

The third schedule covers business income and includes virtually all receipts of the proprietor that are normally expected as part of the business. Any gain on the disposal of movable assets used in the business, and of goodwill, patents, or copyrights developed by the business, will be included in ordinary income. A disposal of real property and of patents, and so on, purchased by the business will yield a capital gain (to the extent that the gain exceeds recaptured depreciation), as will the sale of securities acquired as an investment. Banks and other financial institutions are deemed to be in the business of trading in securities and such gains will be ordinary income in their hands.

Pure capital gains (not realized in the course of business) are regarded as income from casual economic activities and are taxed under a separate schedule on a preferential basis. Gains on the disposal of real property are taxed in full if realized within 7 years of acquisition, and not at all if realized after 10 years from the date of acquisition. Three intermediate steps involve taxing 75 per cent (7 to 8 years), 50 per cent (8 to 9 years) or 25 per cent (9 to 10 years). Gains on property other than real property or shares are also subject to the five-stage inclusion (from 100 per cent to 0 per cent), but the outside time limits are 2 and 5 years. Shares are treated in a similar manner except that if the shares are held for more than 5 years, and if the gain on their disposal exceeds 5 per cent of the sale price, then 10 per cent of the total selling price less an annual deduction

of about $100 is included in income. Gains on property acquired by gift or bequest are only taxable if the property was received from a relative; the cost is based on the donor's acquisition cost.

Generally, exchanges of property for other property are dispositions for purposes of determining tax liability. However, if a business is transferred to a company in exchange for all of its shares, and the corporation values the assets on the same basis as the vendor, then a taxable disposition has not taken place and the cost of the shares is deemed to be the cost of the original assets. Special treatment in the case of mergers is also permitted.

Capital losses are, in general, only deductible from capital gains realized in the same year. Capital losses on shares held for more than 5 years are not deductible from any gains.

SWITZERLAND

The taxation of capital gains varies considerably from canton to canton, with some taxing all gains and some only taxing specific gains or speculative gains. The applicable tax rate also varies as some tax gains at normal rates; others use special rates. Under the federal income tax individuals not engaged in business activities are exempt from tax on capital gains, but all gains of business enterprises that are required to keep books are included in income and taxed at full rates. A merger will not result in tax liability if assets are transferred at book value.

The canton of Zurich taxes in full gains realized on a transfer within seven years of the date of acquisition of non-business personal property if such gains exceed an amount of about $250 in the year. All capital gains on

the transfer of business assets are taxed in full, with the exception of business real property which in effect is only subject to tax on recaptured depreciation. Municipalities in Zurich levy a tax on realized capital gains (in excess of a stipulated minimum) on real property of a business or individual. The tax is at progressive rates based on the size of the gain. The tax is adjusted by an allowance based on the period held (it is reduced by 5 per cent if the property is held for 5 years, with higher reductions for each subsequent year held, up to 50 per cent if held for 20 years or more).

The canton of Basel-Stadt taxes in full all capital gains realized on the transfer of business assets and levies a special capital gains tax on gains from private real and personal property. There is a deemed disposition on death, but transfers in direct line are only subject to 50 per cent of the tax. Losses may only be deducted from capital gains, but if unused in a current year they can be carried forward.

REFERENCE

1/ Government Printer, Pretoria, 1951, para. 35.

SECTION IV

CANADA

BACKGROUND

The definition of "income" in the Income War Tax Act 1/ was amended but little between 1917 and 1947. It was rather lengthy by comparison with section 3 of the current Act and read in part (in 1947):

> 3.(1) For the purposes of this Act, "income" means the annual net profit or gain or gratuity, whether ascertained and capable of computation as being wages, salary, or other fixed amount, or unascertained as being fees or emoluments, or as being profits from a trade or commercial or financial or other business or calling, directly or indirectly received by a person from any office or employment, or from any profession or calling, or from any trade, manufacture or business, as the case may be whether derived from sources within Canada or elsewhere; and shall include the interest, dividends or profits directly or indirectly received from money at interest upon any security or without security, or from stocks, or from any other investment, and, whether such gains or profits are divided or distributed or not, and also the annual profit or gain from any other source....

Although the exact parentage of the Canadian legislation is somewhat questionable, it is clear that both United States and United Kingdom legislation contributed to the issue. At least one authority, after detailing how many sections of the Income War Tax Act were patterned after United States legislation, stated that the concept of income subject to tax varies considerably between the two countries. Plaxton and Varcoe in the first edition of Dominion Income Tax 2/ made the following statements:

> The Dominion Act, though patterned after the United States law as regards its general scheme, differs from it in certain important principles. 3/

> Another important distinction lies in the fact that the United States definition includes profits made from dealings in property

> growing out of the ownership or use of such property. Such gains are not properly taxable under the Dominion Act. 4/

Although they do not quote an authority for this considered conclusion on the treatment of capital gains, the fact that both authors were employees of the Department of Justice is at least an indication of the thinking of some of the taxing authorities in 1921.

It should also be noted that the Canadian Act followed the United Kingdom precedent in employing the word "annual" in the section, while the United States removed it from the Civil War taxing statute in 1867 and apparently never used it again. The United Kingdom courts originally interpreted the word to mean that the charge to tax was on current profits, "annual" meaning "from year to year". In 1921, Plaxton and Varcoe placed great emphasis on the word "annual" and stated that its use in the definition of income excluded "capital gains growing out of the ownership of property". 5/ However, an analysis of the United Kingdom decisions in the 1920's shows that the narrow concept of "annual" which did not permit the taxation of isolated transactions was rejected. 6/ In their second edition in 1930 7/ Plaxton and Varcoe, no doubt influenced by the United Kingdom developments, tempered their emphasis on the importance of the word "annual" in preventing the taxation of capital gains. However, they continued to maintain its importance in determining intention:

> The use of the word "annual" in the definition is important in this connection upon the view that it is there to indicate that the charge is made upon receipts which accrue with some regularity, as, e.g., in the course of business.

As there was no major case in Canada in the early years of the Income War Tax Act, the United Kingdom decisions became, in effect, part of Canadian

jurisprudence before conflict on the question had developed. In any event, the Consolidated Textiles case 8/ in 1947 accepted the United Kingdom interpretation of the word "annual", and the Taylor case 9/ in 1956 established that profits from isolated transactions were not immune from tax under the Canadian Act.

The Canadian Act also included a catch-all phrase "and also the annual profit or gain from any other source including", followed by an itemized list. The United States Act of 1913 contained the words "gains or profits and income derived from any source whatever including" followed by a similar list. While the United States Supreme Court looked in 1921 to the catch-all phrase as authority for the inclusion of capital gains in income, 10/ the Canadian courts from that time until the present have only seldom 11/ attached any particular significance to the words "from any other source" in their attempts to determine the taxability of capital gains. The fact that the United States laws and business climate appear to parallel the Canadian statute and climate did not cause the Canadian courts to take into consideration any United States precedents. Instead, the United Kingdom case law, based to a large extent on the words "adventure or concern in the nature of trade", which did not even appear in the Canadian legislation until 1948, formed the basis for Canadian decisions.

One authority quoted as follows:

> Enough has been said to demonstrate that the English and American theories of income represent two quite different approaches, and further study would reveal other distinctive characteristics. Historically the Canadian position has been an intermediate one, a role in which we not infrequently find ourselves. For our income tax we borrowed our statute law substantially from the United States and our jurisprudence from England. The definition of income contained in the Income War Tax Act enacted in 1917

> has an unmistakable resemblance to United States income tax statutes and bears no resemblance whatever to the English Act. Yet the interpretation given it has followed with few exceptions the decisions of the English courts. 12/

There has thus been no attempt made in the Canadian statute explicitly to define income subject to tax, although the 1917 Act contained considerably greater detail than the 1948 Income Tax Act. Nor is there any definition of the opposite concept—income that is to be exempt from tax. Therefore it has been left to the courts to determine what items shall be income subject to tax. Both the United States and United Kingdom courts had to face this problem prior to the time of the first Canadian income tax act and have been reassessing and clarifying their concepts of income ever since. However, as has already been detailed, the basic approach of these two countries has differed greatly, with the concept of income subject to tax being much broader in the United States than in the United Kingdom.

One explanation for this divergence of approach between the courts of two countries that have historically subscribed to the same legal and business principles may be found by examining the attitude towards land, and its effect on economic concepts in each of the countries. In the United Kingdom, during the time the economic concept of income was developed, agricultural income was the major source of profit. As a result certain attributes of income became generally recognized. It:

(a) was of a recurring nature,

(b) was realized periodically (usually in each year),

(c) flowed from a fixed and constant source,

(d) did not reduce the basic value of the source when separated from that source,

(e) was the result of pursuing a specific activity.

Thus casual or windfall gains—such as might be realized on the sale of land—would be excluded from income. Such gains were regarded as accretions to capital that would be reinvested, rather than as recurring and expected gains that would be consumed. The United Kingdom courts first faced this problem when ruling on the status of various gains received by estates where the opposing claims of the life tenant and the remainderman has to be considered. The life tenant was not to be permitted to encroach upon the corpus of an estate and the enumerated points proved useful in segregating income and capital. As the majority of wealth in the United Kingdom at that time was in estates the concept of income that resulted quite naturally greatly influenced the legislature and the courts in their subsequent deliberations in the field of income tax law. However, there is certainly no legal requirement that the interpretation of a word under one statute (e.g., "income" as related to trusts and estates) must be carried over and similarly applied to another statute that happens to employ the same term. It is, therefore, rather unusual that it took the United Kingdom courts so long to examine the detailed wording of the income tax legislation to ensure that the interpretation of the word "income" was appropriate for this particular Act. One result was the often quoted concept of the tree and the fruit (to be discussed in further detail in a later section) where income could only result from trading in the fruit, while any increments in the tree would be capital accretions.

A contrary view of land and of the gains that could be realized on its disposal was prevalent in the United States. While land was available to few, was scarce, and seldom changed hands in the United Kingdom, in the New World the supply was unlimited and available to all; a relatively rapid turnover of title was not only common, it was expected as an inherent factor in the dynamic growth of the country. Wealth was therefore, to some extent,

based on trading in the land rather than flowing entirely from ownership and farming or rental of the land. Thus capital gains from transactions in land were regarded as part of a man's income to be expended, rather as a capital accretion that must be reinvested.

In both countries securities gradually replaced land as the most important component of individual wealth, but the attitude towards the income status of capital gains remained unchanged.

The early jurisprudence in each country quite naturally reflected its accepted concept of income, although in fact the difference between each country's statutes is not that great. While the legislation in the United Kingdom taxed "the annual profit or gain...from any kind of property whatever... and from any trade", the United States legislature dropped the word "annual" at an early stage and taxed "gains, profits...from...sales, or dealings in property whether real or personal". However, as has already been discussed, the arrangement of the United Kingdom Act differs from that of the United States; only those items of income specifically enumerated in the schedules are subject to tax, while the more general United States wording charges to tax "all income from whatever source derived" to include (but not restricted) certain items which are then listed.

However narrow the difference between the legislation, the courts of each coutry have pursued diverse approaches in determining the taxability of capital gains. The United States courts found that the term "income" included "profit gained through the sale or conversion of capital assets". The English courts were undoubtedly influenced by the historical attitude of non-impairment of capital and therefore narrowly interpreted the word "income" in the context of annual profits or gains from a trade or employment. As a result the

previously enumerated attitudes prevailed and "Casual, non-recurring or occasional profits arising from transactions that do not form part of the ordinary business of the person who makes them are accordingly held not to be within the scope of the income tax, and consequently escape taxation". 13/ The 1955 Royal Commission on the Taxation of Profits and Income felt it was necessary to attempt to clarify the pattern of English jurisprudence by suggesting six criteria for determining if a transaction was a venture or concern in the nature of a trade.

The contrary attitude of the United States courts towards the definition of income can perhaps best be illustrated by the following quotations. In the 1921 Supreme Court case, Merchants' Loan & Trust Co. v. Smietanka, it was contended that the British concept should apply. The Court answered that no United States statute had extended exemption to isolated transactions and that:

> There is no essential difference in the nature of the transaction or in the relation of the profit to the capital involved, whether the sale or conversion be a single, isolated transaction or one of many. 14/

The 1913 Supreme Court decision in Stratton's Independence v. Howbert said:

> Income may be defined as a gain derived from capital, from labour, or from both combined, provided it be understood to include profit gained through sale or conversion of capital assets. 15/

The United Kingdom courts have explicitly stated that the Income Tax Act provides for a tax on income and not on capital. One cannot quarrel with this statement and certainly it would be subscribed to by the United States and Canadian courts. However, this approach is framed in the context of a definition of capital that would not be generally acceptable in the

United States. Thus, the United Kingdom courts to some extent have refused to contemplate an expanded definition of income as it would violate a concept of capital that has remained intact since the 18th century.

This question of the manner in which a term or word of general meaning (e.g., "income") is to be interpreted is one of great importance in assessing the relative functions of the courts and the legislation in the development of our jurisprudence on the concept of income. The following quotations from Maxwell on Interpretation of Statutes (11th ed.) indicate the approach that the court is expected to take in interpreting a statute:

> Every clause of a statute should be construed with reference to the context and the other clauses of the Act, so as, so far as possible, to make a consistent enactment of the whole statute or series of statutes relating to the subject-matter. 16/
>
> In dealing with matters relating to the general public statutes are presumed to use words in their popular sense. 17/

However, it is also well established that in the case of fiscal legislation, the courts must adhere to the wording of the statute rather than favour equitable construction. The principle was stated as follows in a United Kingdom case:

> ...If the person sought to be taxed comes within the letter of the law he must be taxed however great the hardship may appear to the judicial mind to be. On the other hand, if the Crown, seeking to recover the tax, cannot bring the subject within the letter of the law, the subject is free, however apparently within the sphere of the law the case may otherwise appear to be. 18/

The United Kingdom legislation has been developed in a schedular form that lists all the sources of income chargeable to tax. Their courts have chosen to give a narrow interpretation to the word "income" and have been more concerned with the historical meaning of the word in the context of

estates and trusts than in its ordinary meaning in the context of the current economy. The United States has adopted a broad, all-inclusive approach that taxes income from all (and therefore any) sources. Its courts have accepted the reasoning that "income" in the tax legislation has the same meaning as it has "in common use" in the current economic setting. In Canada the situation can be over-simplified by saying the courts have approved of, and have therefore adopted, the English judicial approach despite the fact that they are interpreting a non-schedular statute which taxes "income" from all sources and which includes the phrase "undertaking of any kind whatsoever" that would appear to expand further the scope of the Canadian legislation. United States precedents have generally been ignored despite the similarity of their statute and economy to the legislation and economy in Canada.

The Canadian courts have referred to the words "adventure or concern in the nature of trade" that have been in the English statutes virtually from the beginning even before they appeared in the Canadian Act of 1948. The latter Act also included the "undertaking" phrase that did not appear in the legislation of the United Kingdom—but the Canadian courts have attached no significance to this specific addition included by the legislature in the Act.

This approach of the courts reflects to some extent the declared policy of the government. The Honourable D. C. Abbott in his 1950 Budget Speech declared:

> Perhaps I might also take this opportunity, in view of recent public interest in the question, to assure the house that it is not the policy of the government to tax capital gains. Under any income tax law there is always a very difficult problem in drawing a line between gains which are profits from carrying on a trade or business and those which are not. To my knowledge no tax legislation has ever been passed in any country that has

> removed all doubts on this score. In England, where our basis of income tax has its origin, the matter has been settled almost entirely by the courts, taking into account the facts in each individual case. Much as I would like to introduce greater certainty I do not believe that it can be done satisfactorily by legislation. We now have a readily available Income Tax Appeal Board that has been set up to determine questions of this sort. 19/

The impossibility of differentiating between business and non-business gains was stressed, but no indication was given of how wide the government felt the income net should be. A politically difficult question of public policy was neatly passed over by assigning responsibility to the courts. The following paragraphs, in which Canadian jurisprudence is reviewed, reveal the extent to which this rather unwarranted expectation has not been fulfilled. The discussion rather clearly indicates that, although one might find both the statutes and the courts lacking in this area, the only way to correct the situation is to amend the legislation to clearly indicate (1) what is, and what is not income, and (2) what special treatment is to be accorded to explicitly defined types of income.

JURISPRUDENCE

General Review

In the earlier discussion of United Kingdom legislation it was pointed out that it contains schedules that enumerate the various kinds of taxable receipts and benefits which collectively define the limits of taxable income in England. Even the "sweeping-up" clause therein is of little use, and is incongruous in a system which identifies income only by a process of categorization and which, in consequence, nowhere defines what it is that is to be swept up. Canada, on the other hand, has an act which taxes the income from all sources, including, "without restricting the generality of the foregoing",

income from three enumerated illustrative sources. Income is left to the courts to define, and the courts have turned to English jurisprudence to do this. But the English courts have never had to define income, only having to decide whether a particular receipt is from one of the sources categorized in the schedules. Schedule D charges to tax "the annual profits or gains arising or accruing...from any trade...". As "trade" is defined to include "every trade, manufacture, adventure or concern in the nature of trade", the English courts have had to examine the implications of the words "adventure or concern in the nature of trade".

Despite these variations from the United Kingdom legislation, Canada, in common with the United Kingdom, has developed a "capital gain" concept. "Capital gain", like "income", is not defined in our Act, and is merely a phrase used to describe profits from a business or property which are not, for one reason or another, taxable. A receipt which is relatively certain to fall outside the tax net is a profit from realization of an investment, which by the philosophy that income only is taxed, is regarded as the tree, not the fruit. Other gains may be income (including such dealings in investments that the investments become stock-in-trade, and thus, not trees, but fruit of some other larger operation) and become taxable at full progressive personal tax rates. An early statement of the basic division is found in the Californian Copper Syndicate case 20/ in 1904, where the test of whether an enhanced price was profit within Schedule D was said to be whether the gain was a mere enhancement of value from realization of a security, or was a gain made as an operation of business in carrying out a profit-making scheme.

Thus the courts start with the proposition that a capital gain is an accretion to capital realized on the sale of an investment. From there,

because they have to define "capital", they proceed to the analogy of the fruit and the tree; and because they have to define "investment" they look for a distinguishing factor of investment, which appears to be that it must be capable of producing or of being used to produce income, or of providing enjoyment or benefit to its owner in normal use. However, the problems start when the tree is so dealt with as to become fruit, and the basic question arises: did the taxpayer realize an investment or carry on a trade?

Since the Second World War, many "capital gains" cases involving a great number of situations have been heard in Canada, but all have been variations on the same theme: was an investment sold, or a trade carried on? The touchstones of this question are:

(1) the over-all intention of the taxpayer;

(2) his whole course of conduct in dealing with the subject property.

The Over-all Intention of the Taxpayer

The intention of a taxpayer is looked at both at the time he acquired the property, and when he parted with it. Where the intention throughout was to benefit from normal use of property, or to acquire ordinary income from it in rent, dividends or interest, the gain realized on sale is incidental, or accidental. But an investment intention on acquisition may change to a "trader" intention by the time of disposition. Factors which assist in determining intention are, *inter alia*:

(a) the charter powers of a company, acts done within their ambit probably being within the intention of the company, though what the company actually does is more important;

(b) the character of the subject property, income-producing property being prima facie an investment, while property which only produces a yield by being turned over is not;

(c) multiplicity of similar transactions.

It will be seen that the application of the intention test can be circular. To determine whether the disposition was of an investment or not, one examines the intention of the taxpayer, and to determine that intention, one looks to the nature of the transaction. And the same physical factors found there could indicate an intention to invest or to engage in business. Moreover, the intention test is affected by the rule that accretion to capital does not become income merely because the original sum was invested in the hope and expectation that it would rise in value. 21/ If a person sells at a profit, the mere fact that he hopes and intended to make it will not necessarily transform his acts into the carrying on of a business. 22/ It may be questioned whether this rule, developed under the schedular system in the U.K. where the profit has to arise out of an adventure or concern in the nature of trade, is logically applicable in Canada where income from all sources, including that from an "undertaking of any kind whatsoever", is taxable. However, the rule has been applied by the Supreme Court of Canada in the Irrigation Industries case. 23/

The Taxpayer's Whole Course of Conduct in Dealing with the Subject Property

The courts, because of the difficulty experienced in discovering "intention", have often turned to objective evidence of circumstances surrounding a certain transaction, either from which to glean the intention of the taxpayer or as a separate test in itself. 24/ This is of particular

importance when there is an isolated transaction which, even under the United Kingdom statutory wording, can be taxable. 25/ If the operation is similar to a characteristic piece of ordinary trading in the line of business in which the venture was made, it may be taxable. A single plunge in the waters of trade may be sufficient. The nature of the subject matter may also be of assistance, for, in the Taylor case 26/ in Canada and the Rutledge case 27/ in England, the subject matter excluded the possibility of profit in any other way but by a trading transaction, while in the Irrigation Industries case the nature of the subject matter prevailed against such a finding. 28/

However, this rule is also subject to many exceptions for in certain cases what might have been taken to be a characteristic piece of ordinary trading in the line of business in which the venture was made has nevertheless not been taxed, for instance, where the taxpayer subdivides revenue-producing property (e.g., a farm) and sells it off in lots, and yet is not taxed. 29/

Subsidiary Tests of Taxability

The two "touchstone" tests have been so hedged about by conditions that the courts and learned writers on the subject have developed a bewildering array of subsidiary tests to try to determine taxability. The courts always emphasize that a case is to be decided on its facts, and that a judgment is only a decision in relation to those facts; nevertheless the tradition of precedent, stare decisis and the desire for a logical development in the law, has led jurists to attempt a codification of appropriate tests. The following short review of them will reveal how unsuccessful this has been. It must be admitted that this is partly because of the impossibility of distinguishing between something which does not exist in our law (capital gains) and something else for which there is no precise definition (income).

Intention of the Taxpayer

Although this has been described as one of the two main tests of whether a gain on a transaction is taxable, the courts have also treated intention in such a way that it has at some stages in the juridical history of capital gains in Canada been reduced to the status of just one of several guidelines.

A line of cases culminating in the Regal Heights case 30/ treated intention as an automatic test, in that if there was any intention (even an intention at acquisition which was secondary to the primary intention to hold and use the asset to produce income) to make the profit which was made, the profit was automatically income. Thus, if the primary intended course of conduct was abandoned, even through no fault of the taxpayer, the original alternative intention of reaping a profit by disposition "if all else fails" rendered the profit taxable. And that secondary intention was discovered by looking at the taxpayer's course of conduct. This attitude raised intention from the status of a subsidiary test to a main deciding factor and would appear to give force and effect to those words of the statute which render taxable the profit from an "undertaking of any kind whatsoever".

However, the Irrigation Industries case, supra, and some cases following it, 31/ have reduced emphasis on intention to the point where it is one of many factors so that intention to sell at a profit is not necessarily sufficient to render the profit taxable in the absence of acts in the nature of trade. The problem which faces the taxpayer is that he does not know when the secondary intention test is going to be applied. Sometimes an isolated transaction will provide immunity, 32/ sometimes not. 33/ Also, the very nature of the subject matter will sometimes protect the taxpayer from the

impact of secondary intention, 34/ but on other occasions will not. 35/ Then again, if the taxpayer only formulates his intention to sell at a profit after he has already bought the asset for investment purposes, he may not be taxed 36/ (but he will be taxed if the court does not believe him) 37/ while on the other hand he may not necessarily be taxed even if he had an intention to sell at a profit when he bought the asset. 38/ This is really the root cause of the confusion in this area of the tax law today, and will be illustrated more fully below.

Subject Matter of the Transaction

If the subject matter of the transaction is lead, toilet paper or whiskey, 39/ it is difficult to see how these articles could be trees from which fruit could come. The indicia of an investment—that it must be capable of producing income or providing enjoyment or benefit in normal use—are absent as these articles had to be sold to realize a profit. Assets which do not produce revenue may be held for years without losing their quality as trading assets. However, this test is not free from confusion, for it appears that if the subject matter of an isolated transaction is shares, the profit may not be taxable, 40/ whereas if it is bonds (even more of the traditional idea of an investment) it may well be taxable. 41/ Also, in the Roy case it appears that where a farmer made a profit from gravel he was forced to sell to a Department of Highways, and was held taxable, he would not have been taxable if he had sold the land at a profit under the expropriation threat. 42/

Frequency of the Transactions

In England, it was thought for a time that the profit from an isolated transaction was not taxable, as such a transaction could not be an adventure

or concern in the nature of trade, for "trade" seemed to require some repetition and continuity of action. While in Canada the Taylor case established that isolated transactions were not sacrosanct, 43/ the Irrigation Industries case 44/ reveals that the isolatedness of a transaction may have a bearing on the matter. 45/

Frequency of dealings has on several occasions recently been looked to as the deciding factor. 46/

Regular Business of the Taxpayer

If the gain is from a transaction similar to that in which the taxpayer regularly carries on business it will be income, either because it is indistinguishable from his regular income, or because the transaction is considered to be part of his regular business.

Once a taxpayer has established that a certain type of activity is his business, it is difficult to save subsequent transactions from being taxed. See particularly, Gairdner Securities Ltd. v. M.N.R. 47/ This case shows that when a company has once embarked upon a course of business which is within its charter powers, then, even though it may completely alter its business for a long period of years, any subsequent transaction which bears a marked resemblance to its earlier business will probably give rise to a taxable income. There are two ways around this which reveal the artificiality of this test. First, the charter powers of the company could be changed, and secondly, the contemplated capital transaction could be carried out by a new corporation.

Length of Time the Property was Held

How long must an asset be held before it can be transformed from a trading asset into an investment? There is no fixed time, and assets which do not produce revenue or which were acquired with the evident intent of eventual disposition may be held for many years without losing their original quality of trading assets. Time is not a prime indication of investment intent. However, it creates a presumption when it is coupled with an asset producing a yield. This presumption is strengthened materially when the reasons for disposal are motivated by considerations consistent with investment realization as opposed to trading incentives.

A case indicating that the character of income was not lost over 30 years was the Smith case in 1963, 48/ where property bought in 1930 as a site for a summer cottage was sold off in lots in a long and sustained sequence of sales, the property being held to be the appellant's stock-in-trade. On the other hand, in the Warnford Court case, 49/ the asset was resold in two weeks and yet the profit was not taxable.

Source of Financing for the Transaction

It has often been argued that if money is borrowed to make a purchase, there is an inference of an intention to trade. This has never been a strong indication, and the Irrigation Industries case, 50/ where money was borrowed and the profit on sale held not taxable, makes borrowing to invest not inconsistent with realization of an investment.

The Income Tax Act

The above two touchstone tests and six subsidiary tests have been differently grouped on various occasions 51/ but in the end, it would appear

that simplicity would be attained if it were recognized that what the present Canadian Act intends to do is tax "business" income—that is, the gain from any transaction with a business purpose, or from a "scheme for profit-making". If the Canadian courts returned to Audette, J.'s reasoning in the Morrison case, 52/ the chains of English decisions would be shaken off, and the words of section 139(1)(e) of the Income Tax Act given their full import. In that case, Audette, J. said that the word "trade" should not be given such a restricted meaning as that given by English courts:

> The net is shown with all conceivable wideness to include all bona fide profits or gains made by the subject.
>
> Untrammelled by the English Act and the definition of the word "trade" therein, a word which retains its ordinary meaning, I find that the appellant became liable to taxation...

McDonald, in Canadian Income Tax says:

> Under the Income War Tax Act, the term "business" was used as subsidiary to "trade" in s. 3. Under the present Act, however, the word "trade" is omitted in s. 3, and income is defined as income from "business" or from property. This change in the statutory wording confirms the broad meaning attached to the word "business" in the Morrison decision. Referring again to the Californian Copper Syndicate case, "the question to be determined is the sum of gain that has been made a mere enhancement of value by realizing a security, or is it a gain in an operation of business in carrying out a scheme for profit making?"... There is little merit in the argument that the doctrine of ejusdem generis should be applied to the words "or undertaking of any kind whatsoever", so as to limit the meaning of business to a trade or concern in the nature of trade. This argument was rejected, with reference to similar language contained in s. 3 of the Income War Tax Act, in the Morrison case. 53/

However, McDonald admits that although the wording of section 139(1)(e) seems to impose liability for tax upon profits derived from any undertaking of a commercial character, they have not, and probably never will be, given that interpretation.

McDonald's reference to the wide logical meaning to be given to "undertaking of any kind whatsoever" has led us to review four ways in which the courts might have "thrown the net with all conceivable wideness", but failed.

(1) "Undertaking of any kind whatsoever";

(2) "Income from all sources";

(3) Secondary, or original alternative intention;

(4) The Gloucester Railway case argument.

"Undertaking of any Kind Whatsoever"

A literal reading of sections 3, 4 and 139(1)(e) would appear to impose tax on profits derived from any undertaking of a commercial nature. It has always been of interest as to whether the courts would take note of the phrase which distinguishes the Canadian from the United Kingdom legislation and which makes it more sweeping—the phrase "undertaking of any kind whatsoever". In the Drumheller case 54/ Thurlow, J. relied on the phrase as being wide enough by itself to embrace any undertaking of the kinds already mentioned in the definition "and any other conceivable kinds of enterprise as well". In the Regal Heights case in the Exchequer Court 55/ DuMoulin, J. said:

> If this undertaking falls short of being "...an adventure or concern in the nature of trade..." or at the very least an "...undertaking of any kind whatsoever..." and therefore a "business" as outlined in section 139(1)(e) of our Act, I am at a loss to find a more suitable qualificative.

But these approaches have been shattered by the Valclair case 56/ where counsel apparently for the first time relied on, and directed argument to, the phrase. Kearney, J. dismissed the problem by saying "undertaking" is akin in meaning to "adventure", and the same test is used to determine whether

a profit is taxable under either phrase. In other words, "undertaking" adds nothing to section 139(1)(e) that "adventure in the nature of trade" has not already provided. 57/

"Income from all Sources"

The concept that the Canadian statutes were designed to tax income from all sources, regardless of the motivating force behind the profit or gain realized, is suggested in a few isolated cases. Audette, J. in Smith v. A.-G. of Canada said:

> It is not necessary to inquire into the source from which the revenue is derived, as the tax is a charge imposed by the legislature upon the person, and all his revenues—from whatever source derived—mingle with the rest of the income. 58/

There was always the possibility that the Canadian courts would recognize the distinction between bringing into charge specific items (including the gain from an adventure or concern in the nature of trade) by way of a schedular system, as in the United Kingdom, and the system of taxing income from all sources, including, by way of example, income from business, which in turn includes an undertaking of any kind and an adventure in the nature of trade. This appeared possible when one reads judgments such as those of Audette, J. in Smith v. A.-G. of Canada and of Mignault, J. in McLeod v. Minister of Customs and Excise, 59/ but the more usual approach is typified in the blind acceptance of British decisions by W. S. Fisher, Q.C., in 341 v. M.N.R. 60/ who, ignoring the difference between the Canadian system of taxing income from "all sources", including, as an illustration, income from "businesses" which includes an undertaking of any kind whatsoever, and the United Kingdom system of taxing only the categories specifically described, including "trade" (which is more narrowly defined than is "business" in the

Canadian Act inasmuch as it does not include an undertaking of any kind whatsoever), proceeds comfortingly to say:

> While the Canadian Acts use the term "business" rather than "trade", that term has been used quite often by the British Courts and has been treated as synonymous with "trade". It appears, therefore, that the Canadian definition is no wider than that used in the British legislation, and accordingly, the decisions of the British Courts on a similar problem to that involved in this appeal may be taken as a safe guide for the interpretation of the provisions of our Canadian legislation.

This plausible piece of self-persuasion is unfortunately reflected in the continued reliance on United Kingdom cases. The two words, as defined, are not synonymous unless "business" is not given the full meaning accorded it by the Act. Also, in the differing contexts of taxing by categories in the United Kingdom and taxing all-inclusively in Canada, it is either obtuse or simply an easy way out for any court to say that the decisions of the United Kingdom courts are "a safe guide".

However, in a recent case, the Steer case 61/ the "source" argument was used by the taxpayer to establish that certain losses were deductible; Noel, J. said that:

> ...whether such a transaction is a venture in the nature of trade so as to be a "business" within the statutory definition or cannot be so regarded, it is clearly, in my view, a "source" from which income may arise within the meaning of section 3 of the Income Tax Act [which]...defines "income for a taxation year" to be "income for the year from all sources" which is a single concept. It is not merely the aggregation of one's incomes from all sources from which there were incomes in the year, but it is made up of the gains from all sources minus the losses from these sources or, expressed otherwise, the net income from all sources of income taken together.

This view should supposedly apply equally to gains as to losses.

The Regal Heights Principle

This is a fairly well-defined doctrine whereby the profit on the disposition of a property might be held to be taxable even though, had the taxpayer's original intention been carried out, the property would admittedly have become a capital asset. The court finds that the taxpayer had, or can be deemed to have had, from the beginning an alternative intention to turn the asset to account in whatever way it seemed best if the dominant intention were frustrated. This concept applies where the primary or original intention is investment, but where the taxpayer chooses the subject of his investment with the idea in mind that if his investment project fails, he can sell the asset at a profit. If he does so, the profit will probably be taxed. However, if proof or disproof of intention is difficult, how much more difficult is proof or disproof of secondary as well as primary intention. One can only look at the same indicating factors of surrounding circumstances, the nature of the assets and the taxpayer's course of conduct. 62/ The germ of the idea is found in Anderson Logging Co. v. The King, 63/ where the purpose of buying timber limits was to make a profit "by sale if necessary". The Bayridge 64/ and Fogel 65/ cases in 1959 stated the principle, which was to be enshrined as a test in the Regal Heights case by the Supreme Court of Canada in 1960, where Judson, J. said:

> These promoters were hopeful of putting the land to one use, but that hope was not realized. They then sold at a substantial profit, and that profit, in my opinion, is income and subject to taxation. 66/

Since most directors of companies are men of ability and experience, they would generally have in mind the possibility that an original scheme may be frustrated, and would plan for an alternative course of action if that

should happen. Does the secondary or original alternative intention test mean that in all such cases profits from such a transaction will be taxed? Evidently not. The secondary intention test, developed by the courts with enthusiasm, was soon found to be a dangerous weapon as it went too far if applied logically. Thus, in the Essex House case, 67/ the Exchequer Court refused to use it, and found that the profit from the offer that was too good to refuse was a capital gain. The same might be said of the profits made in the Irrigation Industries case. 68/ The secondary intention test should logically mean that there would be very few non-taxable capital gains left, since most investors must have at the back of their minds the idea that if their investment increases in value to the point where it is economically unwise to hold it, they will sell.

In the Quon and Yuen case in 1962 69/ the Exchequer Court once again refused to apply the secondary or original alternative intention test. The Court accepted the evidence that the purchase was made simply and solely for the purpose stated—for market gardening—and that there was not even a thought amongst the four purchasers beyond that project, whatever the appellants did subsequently. Their intention at the time of purchase was clearly demonstrable, and their subsequent sale was equally clearly fortuitous and unanticipated. This case is an indication that the secondary intention test is often used by the court as a polite way of saying it does not believe the taxpayer in his statement of intention. 70/

By 1962, the view no longer prevailed that the mere holding of vacant land indicated speculation rather than investment. In the Brampton Brick case, 71/ we find opinions expressed which almost certainly would not have found favour four years earlier, when the fact that a taxpayer had engaged

in one admitted "adventure" in the "nature of trade" in the real estate field would probably have been sufficient to label any such further purchases and sales as trading. But Thurlow, J. here isolated the circumstances surrounding the sale from those circumstances where the admitted "venture" was being engaged in and considered the sale on its own merits without presuming trading. He accepted the evidence of circumstances that virtually forced the purchase of 150 acres and absolved the company from a profit-making motive in the purchase of more land than was needed. He also refused to use the secondary intention test for, while recognizing that the directors probably considered how to deal with the excess land at the time of purchase, he did not feel this constituted a profit-making motive or intention.

It was apparent by the end of 1962 that the opportunity presented to the courts to extend section 139(1)(e) to its fullest logical meaning by way of the Regal Heights principle had been rejected.

The Gloucester Railway Case Argument

The Anderson Logging case 72/ is also the starting point for another trend in the Canadian case law towards a broad base upon which to tax, but which also came to an unsatisfactory conclusion. In that case, Duff, J. said:

> ...assuming that the correct inference from the true facts is that the limits were purchased with the intention of turning them to account for profit in any way which might present itself as the most convenient, including the sale of them, the proper conclusion seems to be that the assessor was right in treating this profit as income. [Emphasis added.]

The underlined phrase is not only the starting point of the Regal Heights principle, but it was also referred to by Potter, J. in M.N.R. v. Labadie Ltd., 73/ in conjunction with the United Kingdom Gloucester Railway

case 74/ in order to uphold tax on the basis of a distinction between inventory and a capital asset. In the Gloucester Railway case, the Special Commissioners said:

> ...it makes no difference that one way of making a profit out of the wagons was given up, for the very giving up itself involved the making of a profit in another way out of the same wagons, and the purpose of the company's trade is to make a profit out of wagons. 75/

Rowlatt, J. on appeal said:

> ...the profit made by the appellant company from the sale is simply a profit made by a company whose business it was to make a profit out of wagons in one way or another. 76/

This decision was upheld in the Court of Appeal and in the House of Lords.

With the assistance of the above two cases, Potter, J. in the Labadie case 77/ held the profit made from the sale of 12 demonstrator model cars to be taxable. Despite the fact that the cars were carried on the books as capital assets, Potter, J. said this was not conclusive, and that it was not the true intention of the company to appropriate the cars to plant. Thus, the cars were held to be inventory, and the profit therefrom was a business profit.

Similarly, in the British and American Motors case, 78/ the profit from the sale of nine cars used by the company personnel was held to be taxable. Even though they were shown as capital assets, and depreciation had been taken on them, Cameron, J. said:

> ...I find it impossible to reach any other conclusion than than they were always considered as part of the inventory which would later be sold in the normal course of business. It is true that they were temporarily removed from the stock of cars immediately available for sale. For a short

> period they were held for use of the employees pending sale, but the primary purpose of the respondent was that they would be sold.

Then in the Canadian Kodak case, 79/ the appellant rented out recordak machines, treating them as capital assets and claiming capital cost allowance. As a change of business policy in 1951, it was decided to sell them. It continued to rent out unsold recordaks. It was contended by the appellant that the profit made by it was not a profit from its business. It was submitted that its recordaks had always been regarded by it as capital assets and accepted as such by the taxing authority, that they had never acquired the characteristics of inventory or property held for sale but had always been held exclusively as revenue-producing property from which income was received, that when they were sold the sale was not made with a view to making a profit but for the purpose of freeing capital and of obtaining a wider distribution of machines, that they always retained their characteristics as capital assets and that when they were sold they were sold as capital assets with a resulting capital gain. Thorson, P. said that:

> ...its recordaks were not fundamentally different in principle from the wide range of cameras and photographic equipment and supplies sold by it, that the decision to sell the recordaks was a business decision made for business reasons to increase the appellant's sales and to increase its profits, that from the time of this decision the appellant was in the business of selling recordaks and that its profit therefrom was a profit from its business and taxable income....

He referred to the Gloucester Railway case, and continued:

> Moreover, just as in the case cited the Commissioners did not regard themselves as precluded by the fact that as long as the wagons were let they were treated as plant and machinery from deciding that they were stock in trade when they were sold, and Lord Dunedin considered that "a wagon is nonetheless sold as an incident of the business of buying and selling because in the meantime before sold it has been

> utilized by being hired out", so the fact that the appellant's recordaks were formerly leased and treated as capital assets subject to depreciation does not prevent the profit from their sale being profit from the appellant's business once it has made the business decision to sell them and sold them in the course of its ordinary business of selling photographic equipment and supplies. It was in exactly the same position in which it would have been if it had acquired the recordaks for resale. There was nothing of a capital nature in the sale of its recordaks and it is fanciful to say that they were realizations of investments.

It would appear that these cases present a strong argument for interpreting sections 3, 4 and 139(1)(e) so as to bring into taxable income the profits arising from property held for the purpose of making a profit howsoever realized. Entering into the business of making a profit from property not only involves the adventure or concern in the nature of trade of purchasing and selling that property, but it also involves the holding of that property, if it is shares, to receive dividends; if it is cars, as in the Labadie case, to obtain pecuniary benefit therefrom by allowing employees to use them; if it is a house, by renting it. Thorson,P. in the Canadian Kodak case said that from the time of the decision to sell the appellant was in the business of selling recordaks and its profits therefrom were a profit from business; the fact that they were formerly leased and treated as capital assets does not prevent the profit from their sale being profit from business once the appellant had made the business decision to sell them. It is too narrow to say that a person is in the business of renting houses or in the business of renting recordaks. The proper test is to ask whether he is in the business of making a profit one way or another out of the property, that is, if he is in a "scheme for profit making". If so it makes no difference that one way of making the profit—renting the house or recordaks—was given up, for the very giving up itself involved the making of a profit in another way out of the same property—by sale—and the business and purpose of the owner is to

make a profit out of the property in one way or another.

However, this test has been left unused in so many cases that it would appear that it cannot be applied with any certainty of success. One case of many where the argument could have been applied but was not is Latreille v. M.N.R. 80/ where the appellant could be said to have been in the business of making a profit out of taxis in one way or another in just the same way that the Canadian Kodak Co. was in the business of making a profit out of recordaks, or the Gloucester Railway Co. was in the business of making a profit out of wagons "one way or another". However, when Latreille changed from operating taxis to selling them off, and made a profit on their sale, DuMoulin,J. found the profit non-taxable. This is difficult to reconcile with the Canadian Kodak case. 81/

The use of the distinction between inventory, or stock-in-trade, and capital assets, to determine whether a profit is taxable is a more objective test than the subjective investigation into intention; Cartwright,J. in his dissenting judgment in the Regal Heights case used the test that the lands were not inventory but capital assets and repeated in his dissenting judgment in the Irrigation Industries case 82/ his doubts as to the subjective test of intention. However, that test has prevailed.

Recent Developments

A review of some recent cases illustrates that the task which faces the taxpayer and his advisers is such as to make any accurate forecast of a court's attitude in any given situation almost impossible.

In the last few years there has been no uniformity of application of the secondary or alternative intention test enunciated in the Regal Heights

case. 83/ The waywardness of the court decisions reveals the inadequacy of this test as a suitable guideline for a businessman. For instance, in the Regal Heights case, the majority decision was that the intention of the appellant was to erect a shopping centre, but, if this failed, to sell the land at a profit. On this finding of fact the court found the appellant taxable. This test envisages the prospect of taxing the astute businessman who always has in the back of his mind disposition at a profit if his investment purpose collapses, but of leaving untaxed both the foolhardy one to whom the alternative never occurred, and also the clever one who can sufficiently cover his tracks. Cartwright, J., possibly glimpsing the absurdities to which this test might lead, dissented in the Regal Heights case, and, accepting the finding of fact, put the matter on a more factual basis by saying that the lands acquired and disposed of were not "the stock-in-trade or inventory of a dealer in land" but were "capital assets of a developer of a shopping centre which, owing to circumstances beyond the control of the appellant, it became impossible to develop".

Two years later, in the Irrigation Industries case 84/ Martland, J. for the majority of the Supreme Court seems to have adopted the objective test proposed by Cartwright, J—that of inventory versus capital asset—when he said:

> [Corporate shares] are not, in themselves, articles of commerce, but represent an interest in a corporation which is itself created for the purpose of doing business. Their acquisition is a well recognized method of investing capital in a business enterprise.

At the same time he appeared to reject out of hand a test moulded on the Regal Heights majority decision when he said that the test of:

> ... whether the appellant entered into the transaction with the intention of disposing of the shares at a profit so soon as there was a reasonable opportunity of so doing ....

was not, standing alone, a

> ... sufficient test for determining whether or not this transaction constitutes an adventure in the nature of trade.

Cartwright,J., having a due regard for continuity and the rule of precedent could not accept this. Following the Regal Heights majority decision, he was bound to dissent again, saying:

> To hold otherwise would appear to me to be contrary to the reasoning of the majority in the Regal Heights case.

It is not any part of this review of the recent Canadian case law to determine which of the two tests is preferable; it is sufficient to show that the taxpayer (and his advisers) is left with no clear guidelines. Furthermore, the two concepts have been allowed to develop and diverge, using quite artificial distinguishing features so that the fortunes of the taxpayer are subjected to the whim of the courts with little indication of what tomorrow will bring.

The theory enunciated in the Regal Heights case 85/ was at first taken to the inevitable point where almost any gain on resale of property was taxed, as in the Smith case. 86/ It is inevitable because almost any purchaser of property will have some idea of selling, and at a profit, if things do not work out. In the Smith case, land was held and farmed for five years and then sold at a profit on an unsolicited offer because of taxes and reduced profits from farming. Thurlow, J. said that these facts were consistent with the property having been an investment, but not inconsistent with the purchase

and sale being an adventure or concern in the nature of trade. At this point, there appeared to be a principle emerging that intention to make a profit on the sale of property was enough to make that profit taxable, even if it was intended only to reap that profit as a last resort or after several years of holding the property as revenue property. The same might be said of what emerged from the Laurin case. 87/ In the Adler 88/ and Verret 89/ cases, there seems to have been little difficulty in proving a primary intention to profit by resale.

It appears that an increasing number of taxpayers attempted at this time to establish investment intentions, largely on the basis of successes in the courts of the arguments used in the McGuire case. 90/ However, it rapidly became clear that the original alternative intention test would be used to entrap those the court did not believe, for that test often appears to be a polite way of disbelieving the taxpayer's statement as to his intention. Also, there developed at this time an increasing reliance on the facts as the best indications of intention. Thus in the Gagnon case, 91/ Kearney, J. said that the appellant's declared intentions as to the purchase of the properties were contradicted by his statements, his action for compensation in connection with an expropriation, the fact that he was involved in 22 real estate transactions in eight years and the admission that he was a real estate broker. In the Archibald case, 92/ Kearney, J. said:

> Actions speak louder than words, and it has frequently been held that in circumstances similar to those with which we are now concerned the initial declaration of intent should be accepted with caution and close scrutiny made of how far the subsequent deeds of the taxpayer were consistent with such declaration.

In the Archambault case, 93/ DuMoulin,J. refers to the incredibility of the explanations of the appellant. The inevitable result of this development was that in the St. Aubin case 94/ it was said that intention must be determined by a reasonable deduction from the facts, and in the Sterling Trusts case 95/ it was said that intention could be more accurately deduced from the taxpayer's course of conduct and what he actually did than from his declarations. In these cases, where the facts did not support the appellant's declared intention, it could well be said that a secondary intention existed. Thus it was said that the intention to make a profit on resale could best be deduced from the facts. We shall see that this marks the beginning of the decline of the intention test.

However, despite the development of the original alternative intention test and the associated one of looking to the facts instead of accepting the expressed intention of the taxpayer, we find a few taxpayers succeeding in establishing a non-taxable capital gain. In the Essex House case, 96/ Thorson, P. found that where the taxpayer company built an apartment block, listed it with an agent, and sold it within a year, nevertheless the profit was not taxable. The price was thought to be prohibitive, (though the sale would appear to discount this) and it was listed only because of the constant pressure of the agent. Thorson, P. said this was not an adventure or concern in the nature of trade, in that it was not a profit from a gain made in the operation of business in carrying out a scheme for profit making. This success was followed by the Quon and Yuen case, 97/ where 40 acres purchased to establish a market garden were sold one and one-half years later, it having been determined that the yield from market gardening would not be commensurate with the value of the land, a Royal Commission Report on Metropolitan Development having increased the value of the land. The secondary intention

argument does not appear to have been raised. It was raised, however, in the Lyons case, 98/ where, after mortgage monies could not be raised, the purchased property was sold at a profit one and one-half years later. Cattenach,J. refused to infer an intention to turn the property to account by whatsoever method might be expedient. Despite the evidence of the small amount of equity capital available, he accepted the intention to realize profit through investment, and also accepted the evidence that the sale was forced on the appellant by an action brought by the mortgagee. The high point of taxpayer success in this period was reached in the Brampton Brick Ltd. case, 99/ where a company wishing to buy 50 acres was obliged to buy a complete farm of 150 acres, the mortgage allowing for sale of parts of the land. Three years later a road was built, creating an attractively situated corner lot, which the company offered for sale as a service station lot, and sold at a profit. There were two other transactions in land by the taxpayer, one of which was admitted to be taxable. Nevertheless, Thurlow, J. said:

> ...while I do not doubt that before acquiring the 150 acres the directors of the appellant considered what might be done with the portion that would not be required for the extraction of clay and how it might be turned to advantage whether by using it or disposing of it, on the evidence, I can discover no good reason for thinking that there were prospects at that time of selling such portions to advantage or that prospects of selling them at a profit even constituted a motive for making the purchase.

These cases appear to establish then that if the intention to sell at a profit was as a result of a subsequent turn of events, the profit is not taxable. The secondary intention must be an original secondary intention. This point was established once again in the Warnford Court case 100/ in 1964.

However, there were still, of course, cases where the doctrine of secondary intention found legitimate application; in the Archambault case, 101/

already referred to, DuMoulin, J. said that as an alternative to not finding the appellant's explanation credible, he found that the carelessness shown by an experienced industrialist in not checking by-laws before buying land on which he said he intended to build offices and residences for himself and his associates proceeded from the certainty of a very profitable resale in cases of a prohibition to build. And in the Perron case, 102/ the appellant, being unable to lease warehouse space satisfactorily, sold the building two months after purchase; the building was held to have been acquired with the over-all intention of turning it to account for profit, and the possibility of sale of the building for profit was a secondary objective for acquiring it. Also, in the Doctorow case, 103/ it was held that the transactions in question were mere variations from the taxpayer's regular practice of rapid turnover in his real estate transactions, and while his primary intention may have been to obtain an income return on the capital invested, this intention was abandoned.

One judge who appears to have been more prepared than most to give "business" the full meaning ascribed to it by section 139(1)(e) is Kearney, J. In the Archibald case, 104/ he made a comment which is illuminating as to his approach:

> It would be exaggeration to say that, when the definition of "business" was extended to include "an adventure or concern in the nature of trade", it provided a catch-all clause, but it certainly encroached on the field of tax-free capital gains. [Emphasis added.]

In the Jarry case, 105/ Kearney, J., when dealing with the sale of land which it was intended was to be used to build a shopping centre and houses, but which was sold because of financial difficulties, relied on the Regal Heights 106/ and in the Fogel 107/ cases, saying that the appellants:

> ...in making the investment they did make, knew the whole thing lent itself to alternative uses, and that they, using a popular expression, did not put all of their eggs into the same basket. They believed that if something unforeseen should happen which would prevent them from erecting the kind of houses which they wished to build they still would have the alternative of selling the land as vacant lots at a good profit.

Again, in the Sterling Trusts case, 108/ where land was sold two and three years after purchase of 200 acres, Kearney,J. said:

> I think it is most improbable...that he did not...have "in mind the most obvious alternative course open for turning the property to account for profit".

However, Kearney,J. appears to have been the lone protagonist of the secondary intention doctrine at this time, and as we have seen, there was a line of cases developing where it was held not to apply because the intention to sell at a profit does not appear to have been present at the outset. Unfortunately, even this development is not free from confusion, for in the Cadillac case, 109/ Thurlow,J. refused to apply the secondary intention test, and yet found the appellant taxable even though the intention to sell at a profit appears to have been a subsequent intention. He said:

> ...I do not regard the situation as one in which it should be inferred...that the group when purchasing the property intended to turn it to account for profit by any method that might be considered expedient including resale, though as events turned out that appears to me to describe what they did with it.
>
> ...I can see nothing about the transaction or the circumstances in which it was carried out which establishes or even suggests that the appellant's investment in the property...was merely being realized.

Thurlow,J.'s decision was upheld without any clarification by the Supreme Court of Canada, 110/ it merely being said that there was no error in his

reasons. Thus in a series of cases the secondary intention doctrine was either left unused or rejected as inapplicable, and it appears that the courts were becoming aware of the unlimited nature of such a doctrine, which if unchecked might lead them much further than originally anticipated.

The various trends indicated above were continued in 1963. Relying on decisions such as that in the Brampton Brick case, 111/ the appellants in the Russell and Tanner case 112/ claimed the profit realized on the resale of excess land they had been forced to buy to get the land they wanted was not taxable. However Cattenach, J. found the profit taxable, as the whole course of action was indicative of dealing in real estate. A similar argument in the Fabi case, 113/ that the appellant was forced to buy more than he wanted, was rejected. Thus the possibilities of relying on the Brampton Brick case and the Sterling Paper Mills case 114/ (where the appellant bought wood lots along with the assets it really wanted, and was held not taxable on the profit on this resale, despite a vigorous and intentional campaign to resell), when more land is purchased than needed, were reduced. In the Grant case, 115/ where the taxpayer intended to occupy and farm the land, a well-formulated alternative scheme for developing and selling lots for building purposes was proven. Cameron, J. used the double test that the facts belied his stated intention, and that there was a secondary intention.

> Even if I accepted the evidence of the appellant in the present case that he had in mind the intention to acquire the property as a farm for his own use, it is abundantly clear that such was not his sole intention. At all relevant times there was at least an alternative, and probably the main, intention to dispose of the property as soon as possible, either by promoting a subdivision and selling lots or by sale en bloc.

In the Walker case, 116/ where a partnership formed to build a hotel ran into financial difficulties and sold the concern at a profit to a company

formed to buy it, Thorson,P. found the appellant taxable, both on the basis that the enterprise was an "undertaking" and that it was an "adventure or concern in the nature of trade". This appears to be the only case where Thorson, P. has given consideration to the word "undertaking", having been in most cases intent on expounding "adventure or concern in the nature of trade".

A further inroad into the secondary intention doctrine is to be found in the Dorwin Shopping Centre case, 117/ where the appellant company, formed to develop a shopping centre, ran into financial difficulties and, after refusing several offers, sold the concern at a profit. The appellant was found not taxable thereon. Factors which distinguish this case from the Regal Heights case 118/ are that the centre was completed and high-class materials used. The conditions of sale to the appellant by Dominion Stores were such that the appellant could hardly do other than build.

Up to the time of the Valclair 119/ and Cosmos 120/ decisions, there had been speculation that the Irrigation Industries case 121/ would be strictly limited in application, because that decision seems to have rested partly on the fact that the court was not referred to any reported case where the profit from an isolated purchase and sale of shares by a person not engaged in the business of trading in securities was taxable. However, the Valclair and Cosmos cases applied the Irrigation Industries decision to farm land, a subject matter upon which there are many decisions. At the same time, however, certain statements in the Valclair case render the Irrigation Industries decision more confusing, for Kearney, J. said that in order for a purchase

> ...to qualify as an investment, the object purchased must be at least susceptible of yielding an annual return....

Treasury stock (the "object" in the Irrigation Industries case) is not so susceptible, any more than is toilet paper. 122/ In any event, the annual return was not the only profit sought by the appellant, for

> ...the purchaser anticipated that it would be some years before development would take place in the locality of the property, and its financial position was such that it could easily afford to bide its time.

A clearer indication of the purchaser's secondary intention to reap a profit by eventual disposition cannot be found, and yet the court applied the Irrigation Industries case 123/ instead of the Regal Heights case. 124/ Kearney, J. quoted Martland, J. as saying:

> It is difficult to conceive of any case, in which securities are purchased, in which the purchaser does not have at least some intention of disposing of them if their value appreciates to the point where their sale appears to be financially desirable.

Kearney, J.'s substitution of "land" for "securities" in the above excerpt (which is what his decision does) puts into confusion the Regal Heights principle. But the matter does not end there, for later in 1964, Cattanach,J. in the Villeneuve case 125/ dealt with the situation where the taxpayer purchased land on the outskirts of his city for the purpose of farming (although he never actually farmed it), and some of the land was expropriated and the rest sold. Cattanach,J. applied the Regal Heights test, 126/ saying that:

> ...there can, in the circumstances, be no doubt that the acquisition of thest two farms had for its purpose, or one of its possible purposes, subsequent disposition at a profit....

These words could equally be applied to the Valclair and Cosmos cases, and yet here, Cattanach,J. went on:

...and resulting profits are, therefore taxable.

The only distinguishing feature appears to be that Villeneuve was involved in other real estate transactions both before and after this.

The shopping centre cases proceed on a line of their own, the first being the Jarry case, 127/ where the Supreme Court of Canada, in finding the appellant's profits taxable when he disposed of land originally intended for development as a shopping centre, relied on the "principles of law supporting the decision of this Court in Regal Heights Ltd. v. M.N.R." 128/ Meanwhile the Exchequer Court, in the teeth of the Valclair 129/ and Cosmos 130/ decisions, gave the Lane decision. 131/ Here, extensive promotional work was done to develop the property, the success of which was frustrated because a change in government policy in 1952 resulted in a refusal by Central Mortgage and Housing Corporation to provide the necessary financing. The Regal Heights principle was applied by Noel, J., the Irrigation Industries principle being ignored. Admittedly, the land, being raw land, was not producing an annual return as Kearney, J. says it "must" to be an investment; but neither did the treasury shares in the Irrigation Industries case. 132/ Similarly in the Rothenberg case, 133/ there was extensive promotional work towards developing a shopping centre, which was frustrated. Kearney, J. said that retention as an investment could not be the only intention of knowledgeable and experienced real estate businessmen to the exclusion of all other possible uses of the property.

The Miller case 134/ swings the pendulum back again, with an enunciation of the obverse of the Regal Heights principle. Here there could have been no intention at the time of purchase of the farm land to sell at a profit, as the "explosive boom" in land values came as a result of an unheralded

announcement by an oil company to build a gas absorption plant in the area with a consequential increase in population and land values. Thorson, P. held that the sale by the appellant to Miller Holdings Limited, at a profit of some $36,000, of a block of land was not taxable. Although the taxpayer had by then "embarked on an adventure or concern in the nature of trade in dealing in land", it did not necessarily follow that the profit was "profit from the adventure or concern in the nature of trade on which he had embarked"; he found that "it resulted solely and exclusively from the explosive boom in land values". The decision may be in accord with the case-law, but the reason for it is another test to contend with; that is, did the appreciation in value occur before the owner decided to reap his profit?

The Hortick 135/ and Warnford Court 136/ cases were heard within two months of each other and are difficult to reconcile. In the Hortick case, three associates purchased land and buildings for $120,000 and sold it five weeks later for $450,000 as a result of an unsolicited offer. DuMoulin, J., impressed by the idea of a $330,000 gain in five weeks, found the transaction taxable. In the Warnford Court case, the building was purchased for $435,000 and sold two weeks later for a profit of $85,000 as a result of an unsolicited offer. Jackett, P., said that the quick resale and profit was not in this case conclusive of a taxable profit, and he found the Regal Heights principle inapplicable, as there was no evidence of secondary intention.

Mainwaring, 137/ Robertson 138/ and Ker 139/ were three of five associates concerned in the incorporation of Britalta Petroleums Ltd., and they all profited from the sale of shares therein (as did Mrs. Mainwaring, 140/ but her profit was held not to be taxable). Mainwaring purchased 125,000 shares at 1/2¢ per share and disposed of 70,000 at between $2.65 and $9.35

per share. The case relied on by the appellant was the Irrigation Industries case, 141/ but DuMoulin, J. said that there the deal was an isolated transaction where the directors did not participate in the organization of the mining company, whereas here, the appellants were the promoters. In the Robertson case, the Supreme Court of Canada failed to avail itself of the opportunity presented to illuminate some of the darker corners of the Irrigation Industries decision, contenting itself with an oral concurrence with Kearney, J.'s judgment. Kearney, J. had distinguished the Irrigation Industries case on the same ground as did DuMoulin, J., but he did quote from it as follows:

> In my opinion, a person who puts money into a business enterprise by the purchase of the shares of a company on an isolated occasion, and not as a part of his regular business, cannot be said to have engaged in an adventure in the nature of trade merely because the purchase was speculative in that, at that time, he did not intend to hold the shares indefinitely, but intended, if possible, to sell them at a profit as soon as he reasonably could. I think that there must be clearer indications of "trade" than this before it can be said that there has been an adventure in the nature of trade.

Kearney, J. left this quotation unexplained despite its obvious support of the appellants. Cattanach, J., in the Ker case, was content to ally himself with his brother judges.

In the Thibeault case, 142/ the appellant entered into partnership with a civil engineer to develop vacant land by building houses thereon for sale. The profits from lots disposed of during the partnership were taxed. The appellant abandoned her appeal in respect of them, and in any event, Kearney, J. said that she had "launched into the world of commerce". However, when the partnership was dissolved, she disposed of the rest of her property at a profit. Despite the Regal Heights principle, 143/ Kearney, J. held this profit was not taxable, the appellant, in his opinion, having ceased to carry

on business when the partnership was dissolved. It is difficult to reconcile this case with those situations where, the taxpayer's original development intentions having been frustrated and abandoned, he would still be taxed on the disposition of the property at a profit.

Also, in the Raby case, 144/ despite a similar dissolution of the partnership, and a subsequent disposition of Raby's share of the partnership property at a profit, DuMoulin, J. said that the profit was from the sale of inventory pursuant to section 85E(1); even though the business had ceased to be carried on, the sale was deemed to be made in the course of carrying on the business. It is difficult to appreciate why this was not so in the Thibeault case.

In the Fraser case 145/ the Supreme Court of Canada upheld Cameron, J.'s application of the Regal Heights principle. Cameron, J. said:

> In my view, the whole scheme was of a speculative nature in which the promoters envisaged the possibility that if they could not complete their plans to build and retain as investments a shopping centre and apartments, a profitable sale would be made as soon as it could be arranged.

Judson, J. appears to have been embarrassed by such a straightforward application of the Regal Heights principle, for he said:

> In spite of the Judge's emphasis on primary and secondary intention, when applied to the facts of this case it amounts to no more than this. He was saying that two active and skilled real estate promoters made a profit in the ordinary course of their business, and this they obviously did. They were carrying on a business; they intended to make a profit, and if they could not make it one way, then they made it another way.

This case contains another confusing point. The taxpayer's profit was from the sale of shares, not of land itself, though the companies were

holding companies. Judson, J. rips through the corporate veil by saying that:

> ...this was merely an alternative method that they chose to adopt in putting through their real estate transactions. The fact that they incorporated companies to hold the real estate makes no difference.

This is a difficult statement to reconcile with other authorities. For in the Irrigation Industries case, 146/ the asset disposed of was shares, the substratum of which was an asset of the most speculative kind imaginable—an unproven mine. In the Fraser case, the substratum is land, described in the Valclair case 147/ as "one of the oldest types of long-term investment". Furthermore, one of the reasons for the Irrigation Industries decision was the dearth of cases where the profit from the disposition of shares by someone not engaged in the business of trading in securities was taxable. By the time of the Fraser case, the court had the Irrigation Industries decision before it that such profit was not taxable. The distinguishing feature appears to have been that Fraser was, like Mainwaring, 148/ Robertson 149/ and Ker, 150/ an incorporator of the company, the shares of which were sold. However, this distinguishing feature was not available to Gibson, J. in the Whittall case, 151/ for Whittall was not an incorporator of the companies, the shares of which he sold at a profit, though he was a director. Counsel for the appellant pointed out that he was an investor in his personal capacity, and could not be said to be engaged in the business of trading in securities merely by reason of his employment by a brokerage firm. Despite this argument, and despite the Irrigation Industries case, 152/ Gibson, J. found the profits taxable. He also found the appellant taxable because he was a director and therefore in a fiduciary position vis-à-vis the companies. It is not clear what this has to do with taxing profits from a business. Then in the Weir case, 153/ the

profit from short-term government bonds, dealt in not by an investment dealer but by a manufacturing company, was held to be taxable. This would appear to nullify the suggestion in the Irrigation Industries case that corporate securities are "in a different position" because they are an "investment" and not "articles of commerce".

In the Talon case, 154/ the asset involved was a group of retained carried interests pursuant to oil farm-out agreements. These were sold at a profit, and the Minister contended that the development and sale of such interests was the very business of the company. Gibson, J. put the question as follows:

> Was the appellant in the business of trading in securities when it acquired and disposed of these carried interests? Did these transactions constitute dealing in mining securities? Is the proper inference to be drawn from these transactions that the appellant was not a developer but instead a trader?

Applying the Irrigation Industries case, Gibson, J. answered these questions in the negative.

Up to this point, it was hopeful that an isolated transaction was the feature which distinguished the Irrigation Industries, 155/ Valclair, 156/ Cosmos 157/ and Talon 158/ cases from others; however in the West Coast Parts case 159/ Cattanach, J. returned to the words of section 139(1)(e), and said that although the badges of trade were missing—that is, (1) that there was no organization set up, (2) there was no multiplicity of transactions, (3) the appellant had no prior association with the business, and (4) there was no scheme, system, business or operation, nevertheless, even if there was no "trade", there could still be an "adventure in the nature of trade".

> A single transaction may well be the latter, without being the former, provided it is essentially commercial. The absence of one or all of the usual badges of trade does not negative the existence of an adventure in the nature of trade.

However reasonable this may be in reference to the words of section 139(1)(e), it does not help the taxpayer to be told by the Supreme Court of Canada that an isolated purchase and sale of treasury stock in a speculative mining venture is not taxable, 160/ and by the Exchequer Court that an isolated purchase and sale of farm land on the outskirts of Montreal, 161/ or the isolated sale of net carried interests in oil farm-out agreements 162/ is not taxable, but by another judge of the Exchequer Court that an isolated loan with a bonus involved is an adventure in the nature of trade, because it is "essentially commercial". 163/

In 1965, the Regal Heights principle was given sporadic attention. In the Harmony Investments case, 164/ Gibson, J. based his decision on the "purpose or possible purpose of subsequent disposition", despite the statement in the Irrigation Industries case 165/ that intention to sell at a profit as soon as one reasonably could is not necessarily sufficient to render the profit taxable. But in the Aldershot case, 166/ despite the Regal Heights case, 167/ Cattanach, J. found the profit made on resale of a shopping centre site was not taxable. There the site was not developed; in the Killarney Properties case, 168/ however, the shopping centre was completed and fully leased and only then sold, the main reasons being because of difficulties in obtaining a permanent first mortgage, and maintenance costs. The offers received appear to have been unsolicited. Kearney, J. referred several times to the real estate experience of the directors of the appellant, and in finding the appellant taxable, refused to follow the Dorwin Shopping Centre case, 169/

and applied the Regal Heights case 170/ and the Lane case, 171/ saying that an alternative intent to sell was evident here. Once again, it appears to have been ignored that the alternative intent to sell was rejected by the Supreme Court of Canada as a determinative factor in the Irrigation Industries case, 172/ a decision which was applied to farm land in the Valclair case. 173/ Here the alternative intention to sell test was applied in the Killarney Properties case, 174/ where the shopping centre was completed, but not in the Aldershot case, 175/ where it had not even been started. The Supreme Court of Canada had an opportunity to resolve these conflicts in the Cadillac Contracting case, 176/ but contented itself with an approval of Thurlow, J.'s judgment.

One area in which the Regal Heights principle has been deliberately restricted is the point in time at which it applies. Jackett,P. in the Warnford Court case 177/ said that it only applies at the time of acquisition and it was not applied in the Miller case 178/ because of the change in circumstances subsequent to the time of acquisition. If an intention to sell arises subsequently, it does not necessarily render the profit taxable. 179/ This point is followed in the Racine case. 180/ There, the partnership purchased a bankrupt machinery trading company, and sold the real estate and the shares in the new operating company at a profit a few months later. That profit was held by Noel,J. not to be taxable, saying that there was nothing in the evidence to justify disbelieving the assertions of the appellants that they did not have in mind at the moment of the purchase the possibility of reselling as a reason for making the purchase. A further limitation is placed on the Regal Heights principle, which restricts it from going to the lengths it was feared it might. Everyone has in mind the possibility of resale of an asset, but this is not necessarily sufficient to attract tax.

Noel, J. in an illuminating passage, said:

> It is not, in fact, sufficient to find merely that if a purchaser had stopped to think at the moment of the purchase, he would be obliged to admit that if at the conclusion of the purchase an attractive offer were made to him he would resell it, for every person buying a house for his family, a painting for his house, machinery for his business or a building for his factory would be obliged to admit, if this person were honest and if the transaction were not based exclusively on a sentimental attachment, that if he were offered a sufficiently high price a moment after the purchase, he would resell. Thus, it appears that the fact alone that a person buying a property with the aim of using it as capital could be induced to resell it if a sufficiently high price were offered to him, is not sufficient to change an acquisition of capital into an adventure in the nature of trade. In fact, this is not what must be understood by a "secondary intention" if one wants to utilize this term.
>
> To give to a transaction which involves the acquisition of capital the double character of also being at the same time an adventure in the nature of trade, the purchaser must have in his mind, at the moment of the purchase, the possibility of reselling as an operating motivation for the acquisition; that is to say that he must have had in mind that upon a certain type of circumstances arising he had hopes of being able to resell it at a profit instead of using the thing purchased for purposes of capital. 181/

The distinction was well drawn, and he repeated his views in the Hazeldean Farm Company Ltd. case 182/ where the appellant company had acquired some 600 acres of farmland on the outskirts of Ottawa in 1944 for $26,500.00, and in 14 years had subdivided and sold 123 rural lots for $60,000.00 and about 70 acres of farmland, retaining and farming the rest until the Federal District Commission acquired it in 1959, the profit upon which disposition it was sought to tax. Despite what are usually taken as indicia of secondary intention, the taxpayer was successful. Noel, J. said that it is still practically impossible to define with certainty the boundary line between income and capital gains. One has to look at a combination of factors, such as intent, whether it was an isolated transaction, the relationship to the

taxpayer's ordinary mode of business and the nature of the transaction, each of which alone may not lead to inference of trade but which, taken together with many other circumstances in their totality, may convince a court. He states as the prime test that it is necessary to ascertain whether the exclusive purpose in the appellant's mind when it embarked on the acquisition was to exploit it as a farm or whether it was acquired also with a view to reselling it at a profit depending on the opportunities that would arise. Was the appellant's intention exclusively to farm it, or had it a dual intent of holding this land and developing it until it became ripe for profitable disposition and in the interim deriving some income from some farming activities and rental of the property. He delimited the doctrine of "secondary intention", by repeating what he had said in the <u>Racine</u> case and once again emphasized that it is what was in the appellant's mind at the time of acquisition which is relevant.

> To give a capital acquisition transaction the dual character of being at the same time a venture in the nature of trade, the purchaser must have had at the time of the acquisition, the possibility of resale in mind as an operating motivation for the acquisition. As a finding that such motivation existed will have to be based on inferences from the surrounding circumstances rather than direct evidence of what was in the purchaser's mind, the whole course of conduct of the appellant has to be examined and assessed.

He concluded by saying that it would have taken an amazing degree of prescience to have foreseen the development of the city in the direction and speed with which it in fact did develop.

Although transactions concerning farm land outside <u>Montreal</u> <u>183</u>/ and <u>Ottawa</u> <u>184</u>/ were successful profits from transactions dealing with land on the outskirts of Calgary were held to be taxable, first by Cattanach, J. in the <u>Sheftel</u> case <u>185</u>/ where the appellants bought the property for a feed-lot,

and later sold it because the area was brought within the city boundaries and zoned so that such a use was prohibited. Despite protestations that the property was purchased for revenue purposes, Cattanach,J. evidently did not believe that such astute business men could have been oblivious to the likelihood of the events which occurred. In the Watson & McLeod Limited case, 186/ the land was again on the outskirts of Calgary, having been purchased for its sand deposits, and having been soon sold to a real estate development company and again the profit was found to be taxable.

Similarly, the Regal Heights principle was applied in the Benaby Realties case, 187/ the Metropolitan Motels Corporation case 188/ and the Mansfield Holdings case 189/. In this last case, Kearney, J. was careful to delimit the extent of the application of this principle by indicating that he would not have found the profit taxable if "the taxpayer's building plans had proceeded to such a point that it could be said that it intended to use the land for building to the exclusion of any other intended use for it". This is a difficult statement to reconcile with the Killarney Properties case 190/, where the shopping centre was completed and leased before sale, and the Consolidated Building Corporation case 191/, where the building was completed before sale.

In the DeToro case, 192/ the same confusing point arises as did in the Fraser case 193/. The profit here was made by the sale of shares of a private company, the substratum of which was land. Cattanach,J. said that the sale of shares rather than land was immaterial. Once again, this ignores the fact that profit from the sale of shares in the Irrigation Industries case was held not to be taxable because:

> Corporate shares are in a different position because they constitute something the purchase of which is, in itself, an investment. They are not, in themselves, articles of commerce, but represent an interest in a corporation which is itself created for the purpose of doing business. Their acquisition is a well recognized method of investing capital in a business enterprise.

If this could be said of treasury stock in speculative mining venture, how much more should it apply to shares of a landowning company, land being "one of the oldest types of long-term investment". The judicial attitude towards the disposal of shares in a landholding company was once again reflected in the 1966 Slater and Ross case 194/. Here, a group of persons were the shareholders in a private company which was formed for the purpose of building an apartment building. The two major and active members of the company were skilled builders with a prior history of building activities. When the building was completed, the shares of the company were sold to some investors through an agent who had approached them while the building was in the course of construction. The court held that the sale of the shares and the profits realized thereby resulted from the carrying on of a business.

On the other hand, in the Foreign Power Securities Corporation Limited case 195/ the appellant was a public investment company, and in 1957 and 1958 it realized profits from the sale of shares of Trans Canada Pipelines Ltd. and Quebec Natural Gas Corporation. The Minister sought to tax these amounts on the grounds that the profits on the sales resulted from an adventure in the nature of trade on the basis of the activities and intentions of the appellant's controlling shareholder, N. T. Investments Ltd., a private investment company, and as a means used by N. T. Investments to transfer its profits. The transactions were also claimed to be underwriting transactions on the part of N. T. Investments. It was held that the appellant was a public

investment company with shares on the market, and even though N. T. Investments acquired control of the appellant during the course of the transactions in question, it did so in the course of investing its moneys in a public investment company, a normal thing to do. Even if the profits were taxable as underwriting transactions in the case of N. T. Investments, they could not be considered as such in the hands of the appellant, a public investment corporation with no prior underwriting activities. Despite the short period during which the securities were held, the appellant's directors would have been remiss in their duties if they had not taken advantage of the unexpectedly high market at the time the securities were sold. Thus, even assuming that the avoidance of taxes was one of the elements which activated the transaction, this did not mean that the profits realized by the appellant resulted from an adventure in the nature of trade and thus were taxable.

In these recent cases, the Regal Heights principle and the Irrigation Industries principle, although to some extent crystallized and delimited, have been on collision course, so that although the taxpayer may have a clearer picture of what he may or may not do than he did three years ago, it is not an understanding which may be gleaned from the application of any logically consistent considerations. The extreme inconsistency of the two streams of cases is highlighted by the two recent cases where a profit was made on the sale of shares; in one, because the substratum of the shares was land, the Regal Heights principle was applied, and the profit taxed, however much land may be a classic form of investment, while in the other, because the substratum was other than land, the Irrigation Industries principle was applied, and the profit not taxed, however speculative the shares. The dichotomy is illogical and inequitable.

REFERENCES

1/ S.C. 1917, Chapter 28, later R.S.C. 1927, Chapter 97 and amendments thereto.

2/ Plaxton and Varcoe, Dominion Income Tax Law, (First Edition), Toronto: The Carswell Company, Limited, 1921.

3/ Ibid., p. 13.

4/ Ibid., p. 142.

5/ Ibid., p. 138.

6/ In Martin v. Lowry [1926] 1 K.B. 550, C.A., at pp. 556-558; 11 Tax Cas. 297, at pp. 311, 312 (where a trade had been carried on from seven to eight months, and the profits were held to be assessable to tax), Pollock, M.R. rejected the proposition that "annual" meant recurring from year to year, and stated, approving the view of Rowlatt, J. that "annual" meant "in the current year"; this decision was affirmed in the House of Lords (see [1927] A.C. 312, H.L. at pp. 315, 316; 11 Tax Cas. 297 at pp. 320, 321), where Viscount Cave, L.C. and Lord Summer quoted the dicta of Rowlatt, J. in Ryall v. Hoare [1923] 2 K.B. 447 at p. 455; 8 Tax Cas. 521 at 526 that annual profits or gains mean "profits or gains in any one year or in any year as the succession of years comes round". See also Leeming v. Jones [1930] 1 K.B. 279, C.A. at p. 294; 15 Tax Cas. 333 at p. 347 per Lord Hanworth, M.R. (for the purpose of "annual" you may have a transaction which takes place in the year and is not recurrent).

7/ Plaxton and Varcoe, Dominion Income Tax Law (Second Edition), Toronto: The Carswell Company, Limited, 1930.

8/ Consolidated Textiles Limited v. M.N.R. [1947] C.T.C. 63; 3 DTC 958.

9/ M.N.R. v. Taylor [1956] C.T.C. 189; 56 DTC 1125.

10/ See Merchants' Loan & Trust Co. v. Smietanka, 255 U.S. (1921), 509.

11/ See, for instance, Audette, J. in Smith v. A-G of Canada [1917-27] C.T.C. 240; 1 DTC 45; Mignault, J. in McLeod v. Minister of Customs and Excise [1917-27] C.T.C. 290; 1 DTC 85; Steer v. M.N.R. [1965] C.T.C. 181; 65 DTC 5115.

12/ J. Harvey Perry, Taxation in Canada, 3rd Ed., 1961, Toronto: University of Toronto Press, p. 45.

13/ Report of the Royal Commission on the Income Tax, 1920, note 8, sec. 85.

14/ Supra, reference 10.

15/ 231 U.S. (1913), 399.

16/ Maxwell on Interpretation of Statutes, 11th Ed., 1962, London: Sweet and Maxwell, p. 19.

17/ Ibid., p. 53.

18/ Partington v. The Attorney-General, L.R. 4 H.L. 100.

19/ House of Commons Debates, March 28, 1950, p. 12.

20/ Californian Copper Syndicate v. Harris, 5 Tax Cas. (1904) 159.

21/ Per Lord Buckmaster in Leeming v. Jones [1930] A.C. 415 at 420, also see Lord Keith in C.I.R. v. Reinhold, 34 Tax Cas. (1953), 389. "The intention to resell someday at a profit is not per se sufficient in this case to attract tax." Also, see reference 22.

22/ Hannan & Farnsworth, The Principles of Income Taxation, 1952, London: Stevens & Sons Ltd.

23/ Irrigation Industries Ltd. v. M.N.R., 62 DTC 1131 at p. 1135; [1962] C.T.C. 215 at p. 223, per Martland, J. "The only test which was applied in the present case was whether the appellant entered into the transaction with the intention of disposing of the shares at a profit so soon as there was a reasonable opportunity of so doing. Is that a sufficient test for determining whether or not this transaction constitutes an adventure in the nature of trade? I do not think that, standing alone, it is sufficient."

24/ Cragg v. M.N.R., 51 DTC 34; 3 Tax A.B.C. (1950-51), p. 203.

25/ Edwards v. Bairston [1955] 3 All E.R. 48 (H.L.).

26/ Taylor v. M.N.R., 56 DTC 1125; [1956] C.T.C. 189.

27/ Rutledge v. C.I.R., 14 Tax Cas. 490.

28/ Irrigation Industries Ltd. v. M.N.R. [1962] C.T.C. 215; 62 DTC 1131.

29/ McGuire v. M.N.R. [1956] C.T.C. 98, 56 DTC 1042; Levasseur v. M.N.R., 18 Tax A.B.C. (1958), 321; 58 DTC 72; Miller v. M.N.R. [1964] C.T.C. 144, 64 DTC 5084.

30/ Regal Heights v. M.N.R. [1960] C.T.C. 384; 60 DTC 1270; preceded by Bayridge Estates v. M.N.R. [1959] C.T.C. 158; 59 DTC 1098; and Fogel v. M.N.R. [1959] C.T.C. 227; 59 DTC 1182.

31/ M.N.R. v. Valclair [1964] C.T.C. 22; 64 DTC 5014; M.N.R. v. Cosmos Inc. [1964] C.T.C. 34; 64 DTC 5020; West Coast Parts Co. Ltd. v. M.N.R. [1964] C.T.C. 519; 64 DTC 5316.

32/ Irrigation Industries v. M.N.R. (supra, reference 28).

33/ Hortick v. M.N.R. [1964] C.T.C. 156; 64 DTC 5094.

34/ Irrigation Industries v. M.N.R. (supra, reference 28).

35/ Robertson v. M.N.R., 64 DTC 5113 (S.C.C.); Mainwaring v. M.N.R. [1964] C.T.C. 341; 64 DTC 5214; Ker v. M.N.R. [1964] C.T.C. 415; 64 DTC 5252.

36/ Miller v. M.N.R. [1964] C.T.C. 144; 64 DTC 5084.

37/ Sheftel v. M.N.R. [1965] C.T.C. 201; 65 DTC 5133.

38/ M.N.R. v. Valclair Investment Co. Ltd. (supra, reference 31); Irrigation Industries v. M.N.R. (supra, reference 28).

39/ Taylor v. M.N.R. (supra, reference 26); Rutledge v. C.I.R. (supra, reference 28); C.I.R. v. Fraser, 24 Tax Cas. (1942), 498.

40/ Irrigation Industries v. M.N.R. (supra, reference 28).

41/ Weir Ltd. v. M.N.R. [1964] C.T.C. 529; 64 DTC 5322.

42/ Roy v. M.N.R., 14 Tax A.B.C. 348; 56 DTC 106.

43/ Taylor v. M.N.R. (supra, reference 26).

44/ Irrigation Industries v. M.N.R. (supra, reference 28).

45/ See, however, West Coast Parts Co. Ltd. v. M.N.R. (supra, reference 31), where profit from an isolated transaction was taxed.

46/ See, e.g., Rothenberg v. M.N.R. [1965] C.T.C. 1; 65 DTC 5001; M.N.R. v. Ryan [1965] C.T.C. 41; 65 DTC 5024; Shuckett v. M.N.R. [1965] C.T.C. 196; 65 DTC 5122; Sheftel v. M.N.R. [1965] C.T.C. 201; 65 DTC 5133.

47/ [1954] C.T.C. 24; 54 DTC 1015.

48/ [1963] C.T.C. 484; 63 DTC 1124.

49/ Warnford Court (Canada) Ltd. v. M.N.R. [1964] C.T.C. 175; 64 DTC 5103; see however Hortick v. M.N.R. [1964] C.T.C. 156; 64 DTC 5094.

50/ See, supra, reference 28.

51/ See Thorson, P. in Taylor v. M.N.R. (supra, reference 26) and the Report of the U.K. Royal Commission on the Taxation of Profits and Income, Final Report Cmd. 9474, p. 39.

52/ Morrison v. M.N.R. [1917-27] C.T.C. 343; 1 DTC 113.

53/ McDonald, Canadian Income Tax, Toronto: Butterworths, 1965, §. 26.1 at p. 249.

54/ Drumheller v. M.N.R. [1959] C.T.C. 275; 59 DTC 1177.

55/ Regal Heights Ltd. v. M.N.R. [1960] C.T.C. 46; 60 DTC 1041.

56/ Supra, reference 12.

57/ Note that the Vancouver Board of Trade at the August 15, 1963 hearing submitted that the "undertaking" phrase should be taken out, as, logically, it rendered it virtually impossible to have a non-taxable capital gain.

58/ [1917-27] C.T.C. 240; 1 DTC 45.

59/ [1917-27] C.T.C. 290; 1 DTC 85.

60/ 15 Tax A.B.C. (1956), 103; 56 DTC 231.

61/ [1965] C.T.C. 181; 65 DTC 5115. "The appeal of this case has been heard by the Supreme Court of Canada, but the decision has not yet been reported as at November 25th, 1966."

62/ See Cartwright, J.'s disapproval of the subjective intention test in his dissenting judgment in Irrigation Industries v. M.N.R. (supra, reference 9).

63/ [1917-27] C.T.C. 198; 52 DTC 1209.

64/ Bayridge Estates v. M.N.R. [1959] C.T.C. 158; 59 DTC 1098.

65/ Fogel v. M.N.R. [1959] C.T.C. 227; 59 DTC 1182.

66/ Supra, reference 12, at p. 390 (C.T.C.), p. 1272 (DTC).

67/ Essex House v. M.N.R. [1961] C.T.C. 270; 61 DTC 1135; also see Warnford Court (Canada) Ltd. v. M.N.R. (supra, reference 30).

68/ Supra, reference 9.

69/ Quon and Yuen v. M.N.R. [1962] C.T.C. 343; 62 DTC 1204.

70/ See, for instance, Sheftel v. M.N.R. (supra, reference 18).

71/ Brampton Brick Limited v. M.N.R. [1963] C.T.C. 57; 63 DTC 1033.

72/ Supra, reference 44.

73/ [1954] C.T.C. 90; 54 DTC 1053.

74/ Gloucester Railway Carriage & Wagon Co. Ltd. v. Inland Revenue Commissioners [1925] A.C. 469; 94 L.J.K. B. 397; 129 L.T.R. 691.

75/ See the [1925] A.C. report at p. 472.

76/ As reported in 129 C.T.R. 691 at 695.

77/ Supra, reference 54.

78/ M.N.R. v. British and American Motors Toronto Ltd. [1953] C.T.C. 177; 53 DTC 1113.

79/ Canadian Kodak Sales Limited v. M.N.R. [1954] C.T.C. 375; 54 DTC 1194.

80/ [1959] C.T.C. 235; 59 DTC 1150.

81/ Supra, reference 60.

82/ Supra, reference 9. "Also see Kearney, J. in G.W. Golden Construction Limited v. M.N.R. [1965] C.T.C. 409; 65 DTC 5221 where he eschewed the subjective tests, and based his decision on a finding that:

"The land...was land acquired by the company as part of the inventory of its business, and was still being held as such inventory when it was disposed of at a profit.""

83/ Supra, reference 36.

84/ Supra, reference 9.

85/ Supra, reference 36.

86/ Smith v. M.N.R. [1960] C.T.C. 391; 60 DTC 1282.

87/ Laurin v. M.N.R. [1960] C.T.C. 194; 60 DTC 1143.

88/ Adler v. M.N.R. [1960] C.T.C. 29; 60 DTC 1031.

89/ Verret v. M.N.R. [1960] C.T.C. 361; 60 DTC 1195.

90/ McGuire v. M.N.R. [1956] C.T.C. 98; 56 DTC 1042.

91/ Gagnon v. M.N.R. [1960] C.T.C. 435; 61 DTC 1009. "This decision was affirmed by the Supreme Court of Canada [1966] C.T.C. 84; 66 DTC 5099."

92/ Archibald v. M.N.R. [1961] C.T.C. 180; 61 DTC 1113.

93/ Archambault v. M.N.R. [1962] C.T.C. 176; 62 DTC 1086.

94/ St. Aubin v. M.N.R. [1962] C.T.C. 520; 62 DTC 1324.

95/ Sterling Trusts Corporation v. M.N.R. [1962] C.T.C. 297; 62 DTC 1185.

96/ Essex House v. M.N.R. [1961] C.T.C. 270; 61 DTC 1135.

97/ Quon and Yuen v. M.N.R. [1962] C.T.C. 343; 62 DTC 1204.

98/ Lyons v. M.N.R. [1962] C.T.C. 478; 62 DTC 1297.

99/ Brampton Brick Ltd. v. M.N.R. [1963] C.T.C. 57; 63 DTC 1033.

100/ Supra, reference 30.

101/ Supra, reference 74.

102/ Perron v. M.N.R. [1962] C.T.C. 457; 62 DTC 1288.

103/ Doctorow v. M.N.R. [1963] C.T.C. 57; 63 DTC 1033.

104/ Supra, reference 73.

105/ Jarry v. M.N.R. [1961] C.T.C. 402; 61 DTC 1239. Affirmed by Supreme Court of Canada [1963] C.T.C. 585; 64 DTC 5001.

106/ Supra, reference 36.

107/ Fogel v. M.N.R. [1959] C.T.C. 227; 59 DTC 1182.

108/ Sterling Trusts Corporation et al (Dignan Estate) v. M.N.R. [1962] C.T.C. 297; 62 DTC 1185.

109/ Cadillac Contracting and Developments (Toronto) Ltd. v. M.N.R. [1962] C.T.C. 275; 62 DTC 1170.

110/ See 65 DTC 5069.

111/ Supra, reference 80.

112/ Russell and Tanner v. M.N.R. [1963] C.T.C. 280; 63 DTC 1177.

113/ Fabi v. M.N.R. [1963] C.T.C. 395; 63 DTC 1249.

114/ 60 DTC 1171.

115/ Grant v. M.N.R. [1963] C.T.C. 248; 63 DTC 1159.

116/ Walker v. M.N.R. [1963] C.T.C. 441; 63 DTC 1280.

117/ Dorwin Shopping Centre Ltd. v. M.N.R. [1963] C.T.C. 411; 63 DTC 1258.

118/ Supra, reference 36.

119/ M.N.R. v. Valclair Investment Co. Ltd. [1964] C.T.C. 22; 63 DTC 5014.

120/ M.N.R. v. Cosmos Inc. [1964] C.T.C. 34; 64 DTC 5020.

121/ Supra, reference 9.

122/ Rutledge v. C.I.R., supra, reference 8.

123/ Supra, reference 9.

124/ Supra, reference 36.

125/ Villeneuve v. M.N.R. [1964] C.T.C. 287; 64 DTC 5174.

126/ Supra, reference 36.

127/ Supra, reference 86.

128/ Supra, reference 36.

129/ Supra, reference 100.

130/ Supra, reference 101.

131/ M.N.R. v. Lane [1964] C.T.C. 81; 64 DTC 5049.

132/ Supra, reference 9.

133/ Rothenberg v. M.N.R. [1965] C.T.C. 1; 65 DTC 5001.

134/ Miller v. M.N.R. [1964] C.T.C. 144; 64 DTC 5084.

135/ *Hortick* v. *M.N.R.* [1964] C.T.C. 156; 64 DTC 5094.

136/ *Warnford Court (Canada) Ltd.* v. *M.N.R.* [1964] C.T.C. 175; 64 DTC 5103.

137/ *Mainwaring* v. *M.N.R.* [1964] C.T.C. 341; 64 DTC 5214.

138/ *Robertson* v. *M.N.R.* [1963] C.T.C. 550; 63 DTC 1367. Affirmed by Supreme Court of Canada, 64 DTC 5113.

139/ *Ker* v. *M.N.R.* [1964] C.T.C. 415; 64 DTC 5252.

140/ *Mainwaring* v. *M.N.R.* [1963] C.T.C. 48; 63 DTC 1029.

141/ *Supra*, reference 9.

142/ *Thibeault* v. *M.N.R.* [1964] C.T.C. 232; 64 DTC 5151.

143/ *Supra*, reference 36.

144/ *Raby* v. *M.N.R.* [1965] C.T.C. 138; 65 DTC 5058.

145/ *Fraser* v. *M.N.R.* [1964] C.T.C. 372; 64 DTC 5224, affirming [1963] C.T.C. 130; 63 DTC 1083.

146/ *Supra*, reference 9.

147/ *Supra*, reference 100.

148/ *Supra*, reference 118.

149/ *Supra*, reference 119.

150/ *Supra*, reference 120.

151/ *Whittall* v. *M.N.R.* [1964] C.T.C. 417; 64 DTC 5266.

152/ *Supra*, reference 9.

153/ *J & R Weir Ltd.* v. *M.N.R.* [1964] C.T.C. 529; 64 DTC 5322.

154/ *Talon Exploration Ltd.* v. *M.N.R.* [1964] C.T.C. 468; 64 DTC 5281.

155/ *Supra*, reference 9.

156/ *Supra*, reference 100.

157/ *Supra*, reference 101.

158/ *Supra*, reference 135.

159/ *West Coast Parts Co. Ltd.* v. *M.N.R.* [1964] C.T.C. 519; 64 DTC 5316.

160/ *See Irrigation Industries* v. *M.N.R.*, *supra*, reference 9.

161/ See M.N.R. v. Valclair Investment Co. Ltd., supra, reference 100.

162/ See Talon Exploration Ltd. v. M.N.R., supra, reference 135.

163/ See West Coast Parts Co. Ltd. v. M.N.R., supra, reference 140.

164/ Harmony Investments Ltd. v. M.N.R. [1965] C.T.C. 14; 65 DTC 5009.

165/ Supra, reference 9.

166/ M.N.R. v. Aldershot Shopping Plaza Ltd. [1965] C.T.C. 31; 65 DTC 5018.

167/ Supra, reference 36.

168/ Killarney Properties Ltd. v. M.N.R. [1965] C.T.C. 101; 65 DTC 5060.

169/ Supra, reference 98.

170/ Supra, reference 36.

171/ Supra, reference 112.

172/ Supra, reference 9.

173/ Supra, reference 100.

174/ Supra, reference 149.

175/ Supra, reference 147.

176/ Supra, reference 90.

177/ Supra, reference 117.

178/ Supra, reference 115.

179/ However, see, contra, the Cadillac Contracting case, supra, reference 90.

180/ Racine v. M.N.R. [1965] C.T.C. 150; 65 DTC 5098.

181/ Supra, 65 DTC 5098 at p. 5103.

182/ Hazeldean Farm Co. Ltd. v. M.N.R. [1966] C.T.C. 607; 66 DTC 5397.

183/ M.N.R. v. Valclair Investment Company Limited [1964] C.T.C. 22; 64 DTC 5014; M.N.R. v. Cosmos Inc. [1964] C.T.C. 34; 64 DTC 5020.

184/ The Hazeldean Farm Co. Ltd. case, supra, reference 163.

185/ Sheftel v. M.N.R. [1965] C.T.C. 201; 65 DTC 5133.

186/ Watson & McLeod Limited v. M.N.R. [1966] C.T.C. 86; 66 DTC 5101.

187/ Benaby Realties Ltd. v. M.N.R. [1965] C.T.C. 273; 65 DTC 5161.

188/ Metropolitan Motels Corporation v. M.N.R. [1966] C.T.C. 246; 66 DTC 5208.

189/ Mansfield Holdings Inc. v. M.N.R. [1965] C.T.C. 305; 65 DTC 5185.

190/ Supra, reference 149.

191/ Consolidated Building Corp. Ltd. v. M.N.R. [1965] C.T.C. 360; 65 DTC 5211.

192/ DeToro v. M.N.R. [1965] C.T.C. 321; 65 DTC 5194.

193/ Supra, reference 126.

194/ Slater, Ross, et al v. M.N.R. [1966] C.T.C. 53; 66 DTC 5047.

195/ Foreign Power Securities Corporation Limited v. M.N.R. [1966] C.T.C. 23; 66 DTC 5012.

SECTION V

CONCLUSIONS

In their attempts to differentiate between income gains and capital gains, the Canadian courts have employed a number of guidelines. The particular factor of intention, discussed in the previous pages, is of importance elsewhere in the Royal Commission on Taxation's study of capital gains where the basis of a concept of income is examined. It has been pointed out that the Canadian courts have been unable to decide how much importance they wish to attach to the factor of intention, having moved from primary intention through secondary intention to reliance on the basic facts as an indication of what the intention really was, irrespective of the declarations of the taxpayer. Intention threatened to be of overriding importance before it became to some extent merely a secondary factor in the analysis of the courts. Thus, even though a taxpayer may now acquire an asset with the primary intention of yielding a profit therefrom by ultimately disposing of it at a gain, the courts may decide the gain is not taxable if the asset is of a particular character. In recent years the courts have vacillated in assigning varying degrees of significance to the presence or absence of an annual return, or of an apparent intention to derive a gain on disposition. The resulting uneven jurisprudence and the concurrent development of two opposing trends in the Irrigation Industries line and the Regal Heights line of cases has compounded the taxpayer's uncertainty with each shift in direction. The proper juridical approach is that each case must be determined on its particular facts, and it is true that no two sets of facts will ever be identical so that there will always be some realignment with every restatement of a principle within the context of the particular facts confronting the judge. This may be acceptable from the standpoint of development of the law—though one might question whether a consistent pattern will ever develop, given the varying approaches of different

judges 1/, and the different points of emphasis made by counsel in each case—but this offers little solace to the taxpayer. An incorrect decision may be reversed by a higher court, or a decision may be confined in its application by subsequent ones, but this is small consolation to taxpayers who make business decisions on the basis of the current law evidenced by the latest cases. Few taxpayers can afford to contemplate an extended legal battle to establish the tax position of their transactions, or can postpone action for years until a particular case with similar facts has been appealed through to the final court. The present wording concerned with this problem has been in the act for 18 years, but it is the general opinion of the business community that the taxpayer is in a worse position than he was in 1949, as far as being able to forecast the ultimate view that the law will take of a particular transaction. This opinion would appear to be supported by the above review of recent cases. Although to some extent developed by the greater persistence of the taxing authorities in seeking out hitherto untried taxable situations and testing them in the courts, the reason for this uncertainty is primarily to be founded on the traditional processes of the law, which with its methods of comparing and distinguishing is unable to cope with such generalizations as are found in section 139(1)(e) in the light of the multifarious transactions of the present day.

As well as reviewing the facts in each particular case, which is sometimes a thinly veiled determination of the taxpayer's credibility, the courts seem to have been influenced by the subject matter of a transaction. Thus while the treatment of gains on disposition of real estate largely depended upon the stage in the development of the intention test the case reached the court, the taxability of the profit on the disposal of equities by other than promoters and stockbrokers has depended more on the

nature of the stock—specifically, whether its substratum was land; if it was not, the disposition thereof would still appear to be inviolate. 2/ Since the legislation does not differentiate between types of property, it is difficult to understand the reason for the particular concern of the courts as to security profits. 3/ It is worthy of note that the approach of the courts to gains on the disposition of equity securities has been relatively consistent. The recent inroads upon this previously tax-immune field has been more because of increased activity by the Department of National Revenue rather than any change of attitude in the courts. The fact that the legislature has not been pressed to amend the legislation is an indication that the taxing authorities are content with the courts' general understanding of the intent of the legislation. This cannot be said of every decision, for the Irrigation Industries case is an example of a case where statements found in the judgment are not in accord with the traditional economic views of the distinction between investment and speculation, nor can they be palatable to the taxing authorities. Such a decision provokes uncertainty, and emphasizes the need for clarifying legislation.

On reviewing the cases discussed in the previous pages, it is difficult to single out examples where a taxpayer realized a gain which was not taxed and which from an economic and equity standpoint should not have been taxed. However, this subject is discussed elsewhere in the Commission's study of capital gains, and the concise conclusion to be reached here is that it is impossible for the courts to develop a consistent and acceptable concept of income from the present wording of the Act. Even a moderate improvement in certainty is only attainable by amending the legislation.

As an example of the implications of the current approach to the Act by the courts, it is useful to review briefly the Irrigation Industries case,

which was decided by the Supreme Court of Canada in 1962. More recent decisions have applied some of the statements in the Irrigation Industries case to support decisions in favour of the taxpayer in cases concerning the disposal of farmland 4/ and carried interests in oil farm-out agreements 5/ as well as in cases where a profit was made in the disposal of shares, 6/ even though not on an isolated occasion. On the other hand, attempts to apply these statements in cases of individuals disposing of shares have not always been successful. 7/ Some decisions in favour of the taxpayer might well have been decided against them prior to, and without the influence of, the Irrigation Industries case, and it is appropriate to consider its facts here, as it is illustrative of the sort of transaction which, although legally not an "adventure or concern in the nature of trade", an "undertaking of any kind whatsoever", income from "property", or "income...from all (i.e., any) sources", nevertheless, from an economic and equity standpoint, should probably be taxed.

In the Irrigation Industries case the Supreme Court reversed the Exchequer Court decision 8/ and, as far as Cartwright, J. in his dissenting judgment was concerned, departed from its own prior decision in the Regal Heights case to find that the profit on the disposal of securities was not taxable despite the following facts:

(a) The shares purchased were treasury stock.

(b) The court found that the purchase was what would normally be called speculative, because there was no intention to hold the shares indefinitely, but rather to sell them at a profit as soon as possible.

(c) The purchase was financed by a bank overdraft.

(d) It was acknowledged that there was no immediate likelihood of dividends as the company was beginning new mining operations.

(e) The taxpayer company had been inactive for years until it purchased some real estate immediately prior to the share purchase.

(f) Over half of the shares were sold at a profit of seventy percent within a month of acquisition.

In effect, it would appear that the transaction was found to be capital in nature as it was an isolated transaction—a factor that supposedly had been well laid to rest by earlier United Kingdom and Canadian decisions. 9/ The resuscitation of this test seems to have been confirmed by the Supreme Court of Canada when, in the subsequent Montreal Trust Company case, 10/ a transaction was again found not to be taxable because of this characteristic.

Martland, J., giving the majority judgment, made the surprising statement that a corporate share is not an article of commerce, but is "in itself, an investment". 11/ This seems somewhat in conflict with decisions of the same court (e.g., in the Regal Heights case) which in effect found an apartment building to be an article of commerce. However, the Court appeared to be disturbed by the fact that no case could be found "in which profit from one isolated purchase and sale of shares, by a person not engaged in the business of trading in securities, has been claimed to be taxable". 12/

This should not really have been a consideration, for the fact that the courts had not considered such a profit before was more as a result of departmental policy than the nature of the subject matter. A test more in keeping with normal business concepts is to determine whether the subject

matter is of a speculative or of an investment nature. In the Scott case 13/ the Supreme Court of Canada was impressed with the highly speculative nature of the subject matter when it upheld Thorsen, P.'s judgment dealing with discount mortgages when he said "the agreements were not securities of the kind that a prudent investor would consider" and "they were certainly not ordinary investments". 14/ The extremely speculative nature of mining shares did not lead the court to a similar conclusion in the Irrigation Industries case. The court also said that the shares were not handled in the same way as a transaction of an ordinary trader or dealer in property of a similar nature, though it is difficult to see how a security dealer approach could have been substantially different.

Thus the capital gains area was expanded "beyond anything previously done by the courts", calling in to "question many of the basic principles that have been established by jurisprudence over many years. If applied indiscriminately as a precedent, this judgment could well render valueless most of this jurisprudence and also lead...." 15/ to the non-taxability of speculative transactions. Martland, J. said:

> ...A person who puts money into a business enterprise by the purchase of the shares of the company on an isolated occasion, and not as a part of his regular business, cannot be said to have engaged in an adventure in the nature of trade merely because the purchase was speculative in that, at that time, he did not intend to hold the shares indefinitely but intended, if possible, to sell them at a profit as soon as he reasonably could. 16/

The effect of this is to make any intention test most uncertain of application.

The first problem is therefore not whether capital gains should be a subject of taxation, but that of defining what in law is to be classified as

a capital gain. The United States courts soon decided that a capital gain was just another type of income subject to tax, being a "profit" gained through a sale or conversion of capital assets". 17/ Therefore the assertions by members of the United Kingdom courts and the Canadian courts that an income tax is a tax on income, and not on capital, is to some extent to be regarded in the United States as a truism of no particular significance. They would point out that the two words are heterogeneous, as the capital is not itself the subject of the tax, for this would amount to a net worth or property tax, but rather than only the profits or gains derived therefrom, and which are, therefore, income, are to be the subject of the income tax. The United Kingdom and Canadian courts have put themselves into an inextricable dilemma. They attempt to divide profits and gains into two groups—income gains and capital gains. As the income tax only applies to a so-called income gain, and as capital gains in this sense are excluded, then somehow a means of differentiation is required. At this stage there exists none of the auxiliary questions of inequity (because of income bunching, illusory gains, or high rates of progressive tax) that lead to questions of the extent to which a particular kind of income should be subjected to tax. The question is purely one of clearly and explicitly setting out those areas where the basic character of the two items are clearly distinguishable. The fact that this task has proved impossible despite years of effort is hardly surprising when to the economist there is not a single characteristic of the one type of profit or gain that cannot be found to apply equally to the transactions which bring about the other kind of profit or gain, except that the law charges one to tax but not the other.

The problem to be discussed in the Commision's other study of capital gains is not to find words which will more explicitly distinguish between

taxable and non-taxable profits and gains, but rather to determine whether capital gains are one of the forms of income which, because of special circumstances, should be subject to preferential tax treatment. If the problem is approached by seeking to determine what kinds of income warrant special treatment, then considerations of economic incentives, taxpayer equity and administrative feasibility are balanced, and an explicitly defined policy is developed to replace the general and poorly defined exclusion that now depends for its implementation upon conflicting and constantly vacillating court decisions.

REFERENCES

1/ See comments by Stanley E. Edwards at the 1962 Canadian Tax Foundation Conference, at p. 89 of the Report:

> In many cases the subjective nature of the determination applies not only to the taxpayer but to the judge. It is no secret that judges take widely different approaches to the question of what types of profits are taxable. This is inevitable where each case is determined on its own facts and without reference to any objective test of taxability which is applied consistently.

2/ See Foreign Power Securities Corporation Limited v. M.N.R. [1966] C.T.C. 23; 66 DTC 5012.

3/ See Irrigation Industries v. M.N.R. [1962] C.T.C. 215; 60 DTC 1131.

4/ M.N.R. v. Valclair Investment Company Limited [1964] C.T.C. 22; 64 DTC 5014; M.N.R. v. Cosmos Inc. [1964] C.T.C. 34; 64 DTC 5020.

5/ Montreal Trust Co. (Trustee of Lodestar Drilling Co. Ltd.) v. M.N.R. [1962] C.T.C. 418; 62 DTC 1214; Talon Explorations Ltd. v. M.N.R. [1964] C.T.C. 468; 64 DTC 5281.

6/ Foreign Power Securities Corp. Ltd. v. M.N.R. [1966] C.T.C. 23; 66 DTC 5012.

7/ Whittall v. M.N.R. [1964] C.T.C. 417; 64 DTC 5266; Mainwaring v. M.N.R. [1964] C.T.C. 341; 64 DTC 5214; Robertson v. M.N.R. [1963] C.T.C. 550; 63 DTC 1367 (affirmed by the Supreme Court of Canada at 65 DTC 5113 without reference to the Irrigation Industries case).

8/ [1960] C.T.C. 329; 60 DTC 1232.

9/ See M.N.R. v. Taylor [1956] C.T.C. 189; 56 DTC 1125.

10/ See, supra, reference 5.

11/ C.T.C. p. 221; DTC, p. 1133.

12/ C.T.C. p. 220; DTC, p. 1133.

13/ Scott v. M.N.R. [1963] C.T.C. 176; 63 DTC 1121.

14/ [1961] C.T.C. 451; 61 DTC 1285.

15/ Mrs. Gwenneth McGregor, Around the Courts, Canadian Tax Journal, May-June, 1962.

16/ C.T.C. p. 219; DTC p. 1133.

17/ Elsner v. Macomber.